<u>Issues in Extraterritorial Application of Dodd-Frank's Derivatives Rules:</u>
<u>Update with Focus on OTC Derivatives and Clearing Requirements</u>

Edward F. Greene, Ilona Potiha[1]

I. Introduction

The global, cross-border derivatives market has faced many regulatory challenges to date. Since the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010,[2] many regulators abroad have faced pressure to implement within their own jurisdictions enhanced regulation of derivatives comparable to that mandated by Title VII of Dodd-Frank. At the same time, foreign regulators are trying to coordinate with the US to limit the explicit extraterritorial reach of certain of the rules adopted or proposed under Dodd-Frank by the SEC or CFTC, including the requirement to register as a swap dealer (SD) or major swap participant (MSP) with the CFTC and security-based swap dealer (SBSD) or major security-based swap participant (MSBSP) with the SEC, the transaction requirements for uncleared swaps with US persons and the requirement that certain swaps be centrally cleared. Dodd-Frank established a regime to regulate the unregulated derivatives market, including regulation of interest rate swaps, non-spot foreign exchange transactions (unless exempted as described below), currency swaps, physical commodity swaps, total return swaps, and credit default swaps.[3] The US has recently taken a more considered outlook with respect to its approach to extraterritoriality and has expressed a commitment to coordinate with other regimes as it adopts its final rules.[4] In turn, EMIR[5] entered into force in the EU on August 16, 2012 (although many of its requirements have yet to be implemented).[6] The current challenges are multi-fold – the cross-border derivatives market is difficult to fathom, important to regulate effectively and central to the proper functioning of global financial transactions. For these reasons, it is critical to achieve a workable framework to create safe markets and effective regulatory coordination with respect to cross-border transactions.

The G-20 reached agreement that the derivatives markets posed risk to the global financial markets and reached general agreement about steps that should be taken by its members on a coordinated basis. First, to the extent possible, derivatives should be standardized and required to be cleared and settled through central clearing parities (CCPs), thereby reducing the contagion risks of counterparty default of the type created by the failure of AIG. Second, to the extent that derivatives could not be

---

[1] Edward F. Greene is Senior Counsel in the New York office of Cleary Gottlieb Steen & Hamilton LLP. Mr. Greene served as General Counsel of the Securities and Exchange Commission from 1981 to 1982 and Director of the Division of Corporation Finance from 1979 to 1981. From 2004 to 2008, Mr. Greene served as General Counsel of Citigroup's Institutional Clients Group. Ilona Potiha is an associate at Ropes & Gray LLP. She is a 2012 graduate of Columbia Law School, where she was a Harlan Fiske Stone Scholar. Ms Potiha graduated magna cum laude, Phi Beta Kappa in Economics from Columbia College, Columbia University in 2009 and has completed internships at the Federal Reserve Bank of New York and the SEC's New York division. The authors thank Regina Purdham for her editorial assistance.

[2] Pub L No 111-203, s 201ff, 124 Stat 1375 (2010) (codified at 12 USC s 5381ff) (hereinafter Dodd-Frank), Wall Street Transparency and Accountability Act of 2010.

[3] Some common derivatives and other products are excluded, i.e., futures, options on listed futures, listed and unlisted options on securities and on broad- and narrow-based security indices, commodity trade options, securities repurchase agreements, depository instruments, security forwards and non-financial commodity forwards intended to be physically settled.

[4] For example, see *Cross-Border Proposed Guidance*, 77 Fed. Reg. 41,214 (Jul. 12, 2012), *Final Exemptive Order Regarding Compliance with Certain Cross-Border Swap Regulations*, 78 Fed. Reg. 858 (Jan. 7, 2013), *Further Proposed Guidance Regarding Compliance with Certain Cross- Border Swap Regulations*, 78 Fed. Reg. 909 (Jan. 7, 2013).

[5] Resolution (EU) No 648/2012 of the European Parliament and of the Council on OTC derivatives, central counterparties and trade repositories (also known as the European Markets Infrastructure Regulation or EMIR), regulates and sets to increase stability in the OTC derivatives markets. The Regulation encompasses reporting obligations for OTC derivatives, clearing obligations for eligible OTC derivatives, measures to reduce counterparty credit risk and operational risk for bilaterally cleared OTC derivatives, common rules for central counterparties (CCPs) and for trade repositories.

[6] *OTC Derivatives Regulation and Extraterritoriality III*, Fin. Insts. Advisory & Fin. Reg. (Shearman & Sterling LLP) (Feb. 8, 2013).

centrally cleared, there should be enhanced requirements applicable to participants and transactions in the over-the-counter (OTC) market. Third, there should be reporting of transactions to transaction depositaries so that regulators can have an overview of the entire derivatives market.

The US addressed these issues earlier than other G-20 members when it enacted Dodd-Frank, which requires the CFTC and the SEC to implement its mandate through rulemaking. The CFTC and the SEC have proposed requiring entities to register with them depending on the level of business done with US persons (as broadly defined) or the location of the transaction; it would also apply US rules to transactions involving US persons. That approach imposes US requirements on non-US entities and counterparties who may already be or are soon to be subject to comparable or different rules in their home countries. The absence of harmonization could result in potential conflict, regulatory arbitrage and possibly undermine the competitive position of entities or counterparties in the US, likely to be the most tightly regulated market. Thus, the issues in this context are whether the US should narrow the extraterritorial application of its rules by relying on a concept called "substituted compliance," and if so, how it would make such a determination.

The derivatives markets have a substantial and extensive cross-border component raising challenging issues with respect to the appropriate regulatory response. For example, while there is agreement that most derivatives should be centrally cleared, who should decide in a cross-border context whether the derivative must be so cleared and through which central clearing party (CCP)? How can optionality be achieved so that counterparties have cross-border access to CCPs without requiring them to be dually registered? How should regulators deal with the situation in which one market does not require central clearing (e.g., US foreign exchange contracts) and other markets do? Given that CCPs will concentrate risk, how should they themselves be regulated if they pose systemic risk? In the context of conflicting requirements in cross-border transactions and the scope of entity level registration under Dodd-Frank, when should the US require registration as an SD (or SBSD) or MSP (or MSBSP) when other jurisdictions are not necessarily contemplating separate registration as a result of derivatives activities but rather are relying on regulation of financial institutions in general? If substituted compliance is not implemented, how should the US measure the activity which triggers registration without building in incentives not to deal in the US or with US persons? What ground rules should be in place to rely on substituted compliance for non-home country entities? With respect to transactional requirements, while regulators should try to achieve minimum global standards through a Basel-like approach, if harmonization does not occur and there are differing standards for margin (initial margin (IM) or variation margin (VM)) and collateral requirements (such as composition and segregation), which countries' standards should apply? Should there be exceptions for end-users of derivatives? Finally, how, if at all, should derivatives transactions between affiliates be regulated? This paper will address these issues. Resolution of these issues requires a decision of whether a regulator's rules must apply to entities and activities outside its territory even if there is conflict with other jurisdictions, or whether there can be reliance on host country regulation to address the concerns of the home country.

The approach of the CFTC, which was the first of the US regulators to begin implementing its Dodd-Frank mandate, was initially perceived to be aggressive because it took the view that compliance with its rules globally when dealing with US persons (broadly defined) was necessary to prevent contagion spreading to the US financial markets in connection with the failure of entities and transactions involving US persons. Initially, the CFTC defined US person so broadly that many transactions and entities outside the territory of the US would have been affected. As will be discussed in this paper, this approach has led to the unusual development of countries and foreign regulators commenting publicly and critically to US agencies, the Congress and the US administration on the US approach and urging restraint, restriction, better coordination and the implementation of substituted compliance. The CFTC has responded with updated approaches designed to address these concerns. All foreign regulators calling for cooperation and substituted compliance agree that the challenge is to establish a framework for determining when substituted compliance would be appropriate. As discussed below, we recommend that the Financial Stability Board (FSB) be called upon to develop such a framework.

In turn, the SEC seems to have learned from the reaction to the CFTC's rulemaking, which preceded the SEC's; although its proposed framework is not substantially different, the SEC seems to be taking a somewhat territorial approach, though there are still significant extraterritorial effects of its proposals. While Dodd-Frank did recognize the extraterritorial potential impact of what it requires the agencies to do and called for consultation and cooperation among regulators, it remains to be seen how far the agencies are willing to go in terms of coordinating their rules with each other and other countries. The CFTC seems to be taking the approach that US rules should and will apply, but it will delay their application, giving other markets the opportunity to bring their rules closer to those the US is considering to avoid conflict. Other nations, however, highlight the need for a less aggressive approach. They believe principles should be agreed in advance of unilateral action, in addition to implementing substituted compliance with rules in markets outside the US where non-US counterparties are located (host countries).

Substituted compliance involves judgments about how the host country will interpret, comply and enforce its different standards, and whether those standards achieve the outcomes they are designed to achieve. To the extent that these standards are being newly implemented at the same time as those of the home country, how can the home country be certain that those outcomes will be achieved if it is to rely upon substituted compliance with respect to the new regulatory structure? Some regulators have suggested that the home country look to how the host country has complied in the past with other international standards in making that determination, though it is not clear how that compliance should be assessed. If that were a sensible approach to pursue, an international body such as the FSB might be tasked with assessing on a regular basis compliance by key markets with such international standards, much as the IMF does.[7]

This paper will update the discussion of potential conflicts in the cross-border derivatives regulation between the EU and US set out in *Examining the extraterritorial reach of Dodd-Frank's Volcker rule and margin rules for uncleared swaps—a call for regulatory coordination and cooperation*.[8] It will also update the *Examining the Extraterritorial Reach*'s recommendations and proposed frameworks for coordination of extraterritorial rules in the global derivatives market. Fear of contagion spreading to the financial markets of the home country in the context of cross-border default can understandably result in a preference for the home country to apply its rules globally when dealing with its "persons" notwithstanding conflict. The challenge is to address the home country's concerns through developing a framework in which it can have confidence in relying on other jurisdictions whose rules and oversight differ from its own.

II. Summary of extraterritoriality issues and proposals from *Examining the Extraterritorial Reach*

The following summary of parts of *Examining the Extraterritorial Reach* provides the background for the extraterritoriality issues that have arisen under Dodd-Frank, following which is an update of issues that have arisen since April 2012, the date of the paper.

[7] Standards in the areas of data, fiscal transparency, and monetary and financial policy transparency have been developed by the Fund while others have been developed by other standard setting bodies, including the World Bank, the Basel Committee on Banking Supervision, and the Financial Action Task Force (FATF).
[8] Edward F. Greene and Ilona Potiha, *Examining the extraterritorial reach of Dodd-Frank's Volcker rule and margin rules for uncleared swaps—a call for regulatory coordination and cooperation* ,7(3) Oxford University Press, Oxford Journals: Capital Markets Law Journal 271-316 (2012) (hereinafter *Examining the Extraterritorial Reach*)

a. Dodd-Frank

In an effort to create a safe cross-border derivatives market, Dodd-Frank[9] established a regime to regulate entities and activities outside of the United States (which the CFTC calls cross-border activity). Extraterritoriality has been a controversial, but legal[10] and necessary aspect of US financial regulation, justified by concerns about reducing systemic risk to US financial markets and protecting US investors and counterparties.[11] Title VII of Dodd-Frank[12] repealed the Commodity Futures Modernization Act of 2000 and created a new regulatory structure for the derivatives market. Swaps are jointly regulated; the CFTC is the primary regulator, but the SEC regulates a category of swaps called "security-based swaps[13]". Title VII provides for entity-level regulation (requiring, for example, the registration of SDs and MSPs[14]) and transaction-based regulation, which involves the adoption of rules governing certain aspects of individual swap transactions (e.g., capital, liquidity, margin, risk management, margin segregation, clearing and trading). The margin rules,[15] which cover initial and variation margin and apply to all covered entities (SDs and MSPs), are transaction based and apply to both counterparties of the swap transaction at the level of the individual transaction, regardless of where the transaction takes place (if one of the counterparties is a US person). Compliance with the entity-level requirements is the responsibility of the covered entity, and not its counterparty whereas the transaction-level requirements will affect both parties to a swap.[16]

Dodd-Frank granted explicit powers to the SEC/CFTC to adopt rules applying outside the US.[17][18] It recognized, however, that extraterritorial application of its laws was likely to be controversial and called for coordination and cooperation among regulators to reduce conflict.[19]

---

[9] Pub L No 111-203, s 201ff, 124 Stat 1375 (2010) (codified at 12 USC s 5381ff) (Dodd-Frank).
[10] *Examining the Extraterritorial Reach*, Part 1. Consistency with international law and NAB v. Morrison.
[11] Id. Built into law and policy of safety and soundness and contagion prevention
[12] Wall Street Transparency and Accountability Act of 2010.
[13] The SEC has not yet finalized most of its substantive rules.
[14] Title VII of Dodd-Frank created two new categories of registration for SDs and MSPs. SDs and MSPs are subject to comprehensive, substantive regulation, including capital, margin, documentation, reporting, recordkeeping, and internal and external business conduct requirements.
SD: An entity is regarded as a swap dealer if it: (i) holds itself out as a dealer in swaps; (ii) makes a market in swaps; (iii) regularly enters into swaps as an ordinary course of business for its own account; or (iv) engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps. Dodd-Frank provides a de minimis exception from designation as a swap dealer for a person that enters into less than $8 billion of gross notional value in swaps over the preceding twelve months. Under the CFTC's current cross-border proposed guidance and exemptive order, the calculation of the de minimis threshold excludes swaps with non-US persons and foreign branches of US persons that are registered as swap dealers.
MSP: Even if an entity is not an SD, it may still become subject to registration with the CFTC if: (i) it maintains a "substantial position" in any major category of swaps, excluding (I) positions held for hedging or mitigating commercial risk and (II) positions maintained by an employee benefit or governmental plan, as defined under the Employee Retirement Income Security Act of 1974, for the primary purpose of hedging or mitigating risks directly associated with the operation of the plan; (ii) its swaps create "substantial counterparty exposure"; or (iii) it is a private fund or other "financial entity" that is highly leveraged, is not subject to capital requirements established by an appropriate Federal banking agency and maintains a "substantial position" in a major category of swaps.
[15] Promulgated under section 731 of D-F
[16] *US OTC Derivatives Reforms Impact on UK and Other non-US Asset Managers*, Investment Management Association (Oct. 2012).
[17] *Examining the Extraterritorial Reach*, Part 2, Codified extraterritorial mandate in Title VII.
[18] 722(d) of Dodd-Frank. For the extraterritorial mandate as it applies to the SEC's rulemaking, see 722(b) of Dodd-Frank, where rules shall not apply to any person transacting without the jurisdiction of the US unless such person transacts such business in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate to prevent the evasion of any provision of the Exchange Act that was added by Title VII. The extraterritorial reach, as applied to the CFTC's rules, is applied in circumstances in which there is a direct and significant connection to the US.

b. Issues

Many issues have arisen both from a competitive aspect for US institutions subject to heavy regulation and a coordination challenge for regulators of various nations.[20] Since more than one regime is typically implicated in regulating derivatives transactions between counterparties doing business on a cross-border basis, the coauthors framed the issue as *what are the mechanisms by which the US can regulate the global activities of entities to reduce systemic risk to the US and global financial markets without creating a competitive disadvantage in its home market and creating unnecessary conflicts with the rules of other markets?*[21] Recognizing the importance of the issues, US government actors, regulators abroad and private sector groups have expressed concern about the extraterritorial effects of various Dodd-Frank provisions.[22] Given that the regulated conduct engaged in is transactional, uncertainty can result in actors avoiding dealing with counterparties in certain countries, result in regulatory arbitrage, reduce the efficiency of cross-border activity and in the case of the US, undermine the competitive position of US financial institutions. The US traditionally has followed a national treatment model, especially in the securities markets, which provides that if one deals with US persons, US entity registration and transaction-based/rules apply unless narrow exemptions are available or mutual recognition has been implemented (which the SEC started to a limited extent with Australia).[23] However, applying this model to the derivatives market, which is principally institutional with a substantial cross-border component, coupled with a broad definition of US person, will result in conflict with rules applicable in the jurisdiction regulating the counterparty or the jurisdiction in which the transaction occurs, the consequences of which may be counterparties ceasing to do business in the US or with US persons, and those entities who do continue to do business with US persons having fewer resources as a counterparty to avoid registration requirements applicable in the US or to its affiliates.

c. Proposed Frameworks

With the goal of controlling systemic risk while enabling efficient cross-border business, the coauthors proposed, among other frameworks, mutual recognition, with effective cooperation agreements[24] (memorandum of understanding or MOUs) coupled with exemptions -- transacting business without complying with local requirements of the home country, generally restricted to one aspect of law, such as registration.[25] Given the updates to the SEC and CFTC's respective proposed extraterritorial guidance and goals of international coordination, a concept introduced in this paper called substituted compliance is the coauthors' updated recommended approach, better reflective of the cross-border issues with respect to financial transactions, and more flexible than mutual recognition. As will be explained below, unlike in mutual recognition where both markets have to accept each other's general regulatory frameworks, substituted compliance can be unilateral, applied to certain aspects of the host country's regulatory regime and is relevant where other markets may not apply their rules extraterritorially. A caveat to substituted compliance is that there must be a strong conviction that if the activities permitted outside the home country are not regulated to the same degree, there would nevertheless be no contagion

---

[19] 752(a) of Dodd-Frank (expressly requires the SEC and CFTC to seek harmonization with regulators in other countries by consulting and coordinating 'with foreign regulatory authorities on the establishment of consistent international standards' for swaps regulation).
[20] *Examining the Extraterritorial Reach,*. Part 5.
[21] Id. Part 1.
[22] Id. Part 2.
[23] General Rules and Regulations, Securities Exchange Act of 1934, Registration of Brokers and Dealers, Part 240, Rule 15a-6, Exemption of Certain Foreign Brokers or Dealers.
[24] Id. Part 1. The G-20 has recommended global action in numerous summit declarations (see Pittsburgh Summit declaration (September 2009) and Toronto Summit declaration (June 2010)), fn 2, 3, 5 of Part 1.
[25] See Id. Part 5, fn 169.

effect in the home country if there is a default or failure of an institution as a counterparty. Harmonization (or a market convention, such as Basel-like minimum standards) was proposed as an approach for margin, clearing and collateral requirements. If substituted compliance is not available, perhaps because a framework has not yet been agreed, the coauthors encouraged the use of ISDA type arrangements on an interim basis to reflect international standards or private agreements with a neutral third party resolving conflicts.[26] The coauthors also proposed limiting entity level requirements to include not the entire organization but rather the transacting sub-entities and limiting the scope of transaction level requirements especially when the transaction occurs outside the US or with non-US counterparties. Ultimately, coordination and cooperation is central. To this end, international organizations can establish norms and best practices.

The remainder of this paper will explore the various updates since *Examining the Extraterritorial Reach* and highlight various cooperation and coordination efforts.

III. <u>Updates/Current State of Play in the Domestic OTC derivatives market and SEC/CFTC Policy</u>

As of late 2012, the size of the OTC derivatives market was $648 trillion,[27] of which a significant amount consists of transactions conducted on a global basis. While the issues mentioned in Section II above remain, numerous efforts have been made by the SEC and CFTC (through a regulatory and policy channel (in many instances consistent with the approaches discussed by the coauthors in *Examining the Extraterritorial Reach*)), and many recommendations have been made, and in some cases implemented, by international bodies, figures and supranational groups. New challenges have arisen, however. For example, the CFTC passed several proposals attempting to limit and delay extraterritorial application which has caused its own set of issues and confusion. Also, the SEC and the European Union have been added to the picture; since *Examining the Extraterritorial Reach* was published, each has proposed its own corresponding derivatives proposals. Countries are at various stages of implementing their derivatives regimes in response to the G-20 commitments. At the same time, regulators are facing the cross-border impact of their individual requirements.[28] This section will discuss recent regulatory initiatives, and will discuss logistics and industry reaction. Additionally it will discuss differences between the SEC and CFTC's proposed approaches to a concept called, "substituted compliance," with the arguably most important difference from the CFTC's approach being the SEC's proposal to allow substituted compliance for transaction-level rules for a security-based swap between a US person and a non-US person.

a. CFTC proposed guidelines and exemptive order (July 12, 2012)

i. <u>Proposed Guidelines</u>. On July 12, 2012, the CFTC published a proposed interpretive guidance and policy statement on the Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act.[29] From an entity registration perspective, one of the most important proposals was the one interpreting the term "US Person" by "reference to the extent to which swap activities or transactions involving one or more such person have the relevant effect on US commerce."[30] The reasons the CFTC specified for the interpretation are practical ease and a way to shield the US markets from harm. The

[26] For jurisdiction, the Restatement (Third) of Foreign Relations Law section 403 (1987) can apply.
[27] Silla Brush, *US Treasury Exempts Foreign Exchange Swaps From Dodd-Frank,* Bloomberg, Nov. 16, 2012, at 2.
[28] John Ramsay, Acting Dir., Div. of Trading and Mkts., US Sec. and Exch. Comm'n, *Cross-Border at the Crossroads: The SEC's "Middle Ground"* (May 15, 2013).
[29] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. pt. 1).
[30] Id.

interpretation is meant to be helpful in determining whether non-US persons engaging in swap dealing transactions with US persons should register and, from a comity perspective, to determine if there is sufficient US interest to require application of US rules.[31] Trying to narrow the extraterritorial scope of the registration provisions, the CFTC noted that a foreign branch or agency of a US entity is a US person; however, a foreign affiliate or subsidiary is not. The proposal also sought to narrow the scope of activity which would require registration as SDs or MSPs based on aggregation and de minimis thresholds. In that regard, it proposed guidance to determine: (1) when a non-US person's swap dealing activities would be sufficient to require registration as a "swap dealer"; (2) when a non-US person's swap positions would be sufficient to require registration as a "major swap participant"; and (3) the treatment for registration purposes of foreign branches, agencies, affiliates, and subsidiaries of US swap dealers and of US branches of non-US swap dealers.

From an extraterritorial application perspective, another important proposal was the proposed application of the Commodity Exchange Act's swaps provisions to registered non-US swap dealers and foreign branches, agencies and affiliates and subsidiaries of US swap dealers.[32] The proposal discusses both the scope of clearing[33] and margin/segregation for uncleared swaps.[34] US persons (branches/agencies) would have to comply with entity level rules[35] and most transaction level rules irrespective of whether the counterparty is a US person, but the CFTC allows for substituted compliance[36] for non-US persons, a process by which a non-US applicant for SD or MSP registration may seek the Commission's acceptance of compliance with a comparable and comprehensive foreign regulatory requirement. Expanded upon in Section III below, substituted compliance is proposed to be permitted for swaps between a foreign branch of a US person and any non-US person counterparty, and is proposed to be entity-based. In a policy-based explanation, "given that the counterparty is a non-US person, coupled with the supervisory interest of the foreign jurisdiction in the execution and clearing of trades occurring in

[31] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. pt. 1). Proposed definition: Specifically, as proposed, the term US person would include, but not be limited to: (i) Any natural person who is a resident of the United States; (ii) any corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund, or any form of enterprise similar to any of the foregoing, in each case that is either (A) organized or incorporated under the laws of the United States or having its principal place of business in the United States 29 ("legal entity") or (B) in which the direct or indirect owners thereof are responsible for the liabilities of such entity and one or more of such owners is a US person; (iii) any individual account (discretionary or not) where the beneficial owner is a US person; (iv) any commodity pool, pooled account, or collective investment vehicle (whether or not it is organized or incorporated in the United States) of which a majority ownership is held, directly or indirectly, by a US person(s); (v) any commodity pool, pooled account, or collective investment vehicle the operator of which would be required to register as a commodity pool operator under the CEA; (vi) a pension plan for the employees, officers, or principals of a legal entity with its principal place of business inside the United States; and (vii) an estate or trust, the income of which is subject to United States income tax regardless of source.

[32] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,223 (July 12, 2012) (to be codified at 17 C.F.R. pt. III B).

[33] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. pt. 1) Section 2(h) of the CEA requires a swap to be submitted for clearing to a DCO if the Commission has determined that the swap is required to be cleared, unless one of the parties to the swap is eligible for an exception from the clearing requirement and elects not to clear the swap. Clearing via a DCO eliminates the risk of settlement for swap dealers or MSPs and their counterparties. Closely interlocked with the clearing requirement are the following swap processing requirements: (i) The recently finalized § 23.506, which requires swap dealers and MSPs to submit swaps promptly for clearing; and (ii) § 23.610, which establishes certain standards for swap processing by swap dealers and MSPs

[34] Section 4s(e) of the CEA requires the Commission to set margin requirements for swap dealers (and MSPs) that trade in swaps that are not cleared.

[35] D1, Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,230 (July 12, 2012) (to be codified at 17 C.F.R. pt. III D).

[36] Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,232 (July 12, 2012) (to be codified at 17 C.F.R. pt. IV), the Commission will use its experience exempting foreign brokers from registration as FCMs under its rule 30.10 ''comparability'' findings in developing an approach for swaps. However, the Commission contemplates that it will calibrate its approach to reflect the heightened requirements and expectations under the Dodd-Frank Act.

that jurisdiction, the Commission believes that it would be appropriate to permit the parties to comply with comparable foreign requirements." In doing so, the CFTC notes that substituted compliance would be based on an evaluation of whether the requirements of the jurisdiction for the entity in question, specifically the jurisdiction in which foreign branches and agencies of US SDs are located and subject to regulation, are as comparable and comprehensive as the corresponding requirement under the Commodity Exchange Act and CFTC regulations based on an evaluation of *all* relevant factors.[37]

Substituted compliance may contribute positively to the goal of coordination among regulators. For coordination, "the Commission contemplates that its approach also will require a more robust and ongoing process of cooperation and coordination between the Commission and the relevant foreign regulatory authority regarding ongoing compliance efforts." For the scope of substituted compliance, the CFTC would determine comparability and comprehensiveness by reviewing the foreign jurisdiction's laws and regulations. If some parts of a foreign regulatory regime are not comparable but others are, the CFTC has broad discretion to permit substituted compliance with only some parts. It notes that a non-US person may request permission to comply with specified comparable requirements in its home jurisdiction in lieu of Dodd-Frank,[38] rejecting an all or nothing approach. Although this approach may raise the issue of compliance oversight complexity, in some ways, substituted compliance is more flexible than mutual recognition in that it highlights certain aspects of laws that can pass under substantive compliance without assessing the comparability of others. That is, it does not call for the equivalence of an entire regulatory regime; it is more issue-based.

ii. Proposed Exemptive Order. While the above proposed guidance attempted to limit the extraterritorial reach of the CFTC regulations, on July 12, 2012, the CFTC also published a proposed exemptive order and request for comment,[39] which allowed for delayed compliance with certain requirements to encourage collaboration and coordination among nations in the derivatives rulemaking process. The CFTC proposed to grant "temporary exemptive relief in order to allow non-US SDs and non-US MSPs to delay compliance with certain entity level [registration] requirements of the CEA…. Additionally, with respect to transaction-level requirements of the CEA…, the relief would allow non-US swap dealers and non-US major swap participants, as well as foreign branches of US swap dealers and major swap participants, to comply only with those requirements as may be required in the home jurisdiction of such non-US SDs and non-US MSPs (or in the case of foreign branches of a US SD or US

---

[37] Factors include (i) The comprehensiveness of the foreign regulator's supervisory compliance program; and (ii) the authority of such foreign regulator to support and enforce its oversight of the registrant's branch or agency with regard to such activities to which substituted compliance applies.

Where foreign regulations are not comparable, the Commission believes that it could be appropriate, in certain limited circumstances, to permit foreign branches and agencies of US swap dealers to comply with the transaction-level requirements applicable to entities domiciled or doing business in the foreign jurisdiction, rather than the Transaction-Level Requirements that would otherwise be applicable to the US person's activities. Specifically, the Commission understands that US swap dealers' swap dealing activities through branches or agencies in emerging markets in many cases may not be significant but may be nevertheless an integral element of their global business. Under the circumstances, the Commission proposes that section 2(i) should be interpreted to permit foreign branches and agencies of US swap dealers to participate in the swap markets in such countries on a limited basis. To be eligible for this exception, the aggregate notional value (expressed in US dollars and measured on a quarterly basis) of the swaps of all foreign branches and agencies in such countries may not exceed five percent of the aggregate notional value (expressed in US dollars and measured on a quarterly basis) of all of the swaps of the US swap dealer.

However, the US person relying on this exception would be required to maintain records with supporting information to verify its eligibility for the exception, as well as identify, define, and address any significant risk that may arise from the non-application of the Transaction-Level Requirements.

[38] IV.2 process. Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, 77 Fed. Reg. 41,214 (July 12, 2012) (to be codified at 17 C.F.R. pt. 1).

[39] Exemptive Order Regarding Compliance with Certain Swap Regulations, 77 Fed. Reg. 41,110 (Jul. 12, 2012) (to be codified at 17 C.F.R. ch. 1).

MSP, the foreign location of the branch) for swaps with non-US counterparties."[40] Commentary from this proposed order would ultimately shape the final order of December 2012, which allows for delayed compliance with CFTC law. Applicable primarily to foreign entities that would be required to register with the CFTC, this delayed compliance order reflected an effort on the part of the CFTC to limit the extraterritorial consequences of Dodd-Frank's provisions as mandated by its rulemaking.

iii. CFTC Statements. In conjunction with the above proposed guidance and final order, various CFTC commissioners have issued explanations or statements, described below. It is highly relevant that most statements emphasize a need for cross-border communication with foreign and domestic regulators, and in some cases reflect disagreements among the Commissioners as to the appropriate shape of the CFTC's rules and the scope of coordination.

On June 29, 2012, Jill Sommers issued a Statement of Concurrence to the Proposed Interpretive Guidance and Proposed Exemptive Order,[41] stressing the need to coordinate with foreign and domestic regulators. Scott O'Malia also issued a statement of concurrence[42] emphasizing the need to communicate with foreign and domestic regulators. Believing that the Commission had an "over-expansive interpretation and application of Title VII of the Dodd-Frank Act," and that "the swaps markets are truly global and the Commission's swaps regulations will not operate in a vacuum," he proposed that the Commission should consider the interaction of its swaps regulations with the regulations of other jurisdictions.

O'Malia highlights essential recommendations previously proposed by the coauthors such as concepts of comparability and mutual recognition. He also believes that the Commission should "follow the example of international cooperation and coordination seen in the efforts of the Basel Commission on Banking Supervision and the International Organization of Securities Commissions in developing harmonized international standards for the margining of uncleared swaps," highlighting a proposal for minimum standards discussed below. Although harmonization is unlikely, in O'Malia's view, "either the G-20 or another international body or consortium of nations could act as a springboard for the coordination of swaps regulation." This approach, to use supranational bodies as a venue for coordination and even the development of minimum standards from which countries may differ is a feasible outcome explored in Section IV below.

b. CFTC no action letter (October 12, 2012)

On October 12, 2012, the CFTC released a no-action letter[43] with respect to entities no longer entitled to rely on the de minimis exception from swap dealer registration and who must therefore register as a SD or MSP. Registration would require determining whether one is dealing with US persons, as defined. Recognizing that the scope of the definition of US person from the July 2012 guidance is an

---

[40] Id.

[41] Jill E. Sommers, Comm'r, US Commodity Futures Trading Comm'n, *Statement of Concurrence: (1) Cross-Border Application of Certain Swaps Provisions of the Commodity Exchange Act, Proposed Interpretive Guidance and Policy Statement; (2) Notice of Proposed Exemptive Order and Request for Comment Regarding Compliance with Certain Swap Regulations* (Jun. 29, 2012), available at http://www.cftc.gov/Room/Speeches Testimony/sommersstatement062912

[42] Scott D. O'Malia, Comm'r, US Commodity Futures Trading Comm'n, *Statement of Concurrence: (1) Proposed Interpretive Guidance and Policy Statement Regarding Section 2(i) of the Commodity Exchange Act; and (2) Notice of Proposed Exemptive Order* (Jun. 29, 2012), available at http:/www.cftc.gov/PressRoom/SpeeechesTestimony/omaliastatement062912

[43] Gary Barnett, Dir., US Commodity Futures Trading Comm'n, CFTC Letter No. 12-22, No-Action, Division of Swap Dealer and Intermediary Oversight, *Time-Limited No-Action Relief: Swaps Only With Certain Persons to be Included in Calculation of Aggregate Gross Notional Amount for Purposes of Swap Dealer De Minimis Exception and Calculation of Whether a Person is a Major Swap Participant* (Oct. 12, 2012).

interpretive issue for foreign counterparties, in a press release,[44] the CFTC noted that "prior to the Commission's issuance of final guidance or a final exemptive order setting forth a definition of 'US person,' foreign entities may adopt either potentially over-inclusive or potentially under-inclusive categorizations of their counterparties for purposes of determining whether their swap dealing activities exceed the thresholds under the SD and MSP definitions and registration requirements. Either result would not be consistent with the Commission's intent." To address that concern, staff issued a no-action letter, which provided time limited no-action relief to foreign entities for failure to include a swap executed prior to the earlier of December 31, 2012 or the effective date of a definition of US person in a final exemptive order so long as the counterparty is not included in a specific set of categories.[45] Further, the Division of Swap Dealer and Intermediary Oversight (DSIO) also believes that time limited no-action relief is warranted for whether a person must register with the CFTC as an SD or MSP as long as the counterparty is not included in the aforementioned categories.

The letter does not give guidance as to which standards to use. Instead, it delays the time to register until the CFTC can enact a final US person definition (as it did in the exemptive order described in (c) below) by providing that it will not take action against entities that have failed to register. As explained above, using the definition of US person, in the CFTC's view, would have lead to unintended results given countries' proposed ways of getting around the potentially restrictive US person definition by adapting categorizations of swaps activities that elude meeting the threshold to register.[46] This no action relief due to confusion surrounding a workable definition of US person (that applies extraterritorially) is an example of the CFTC delaying mandatory compliance so that foreign regulators can coordinate an agreed upon framework for registration. The CFTC recommended an altered definition of US person[47] similar to the one described below in the December 2012 final exemptive order.

c. CFTC exemptive order (December 21, 2012)

i. Exemptive Order. Further using a mechanism to delay the implementation of its stringent extraterritoriality rules in an effort to encourage coordination, on December 21, 2012, the CFTC approved an exemptive order[48] providing temporary relief from certain cross-border applications of the swaps provisions of Dodd-Frank's Title VII. The purposes of the order are (i) to foster an orderly phase in to the new swaps regulatory regime and (ii) to provide market participants greater certainty regarding their obligations with respect to cross-border swap activities.

Under the order, a non-US person that registers with the Commission as a SD or MSP may delay compliance with certain of Dodd-Frank's entity-level requirements. Further, non-US SDs and MSPs and foreign branches of US SDs and MSPs may delay compliance with certain of Dodd-Frank's transaction-

---

[44] Press Release, US Commodity Futures Trading Comm'n, *CFTC's Division of Swap Dealer and Intermediary Oversight Issues No-Action Letter Regarding the Swaps Calculation by Certain Foreign Entities for Purposes of the Swap Dealer and Major Swap Participant Definitions* (Oct. 12, 2012), available at http://www.cftc.gov/PressRoom/PressReleases/pr6390-12
[45] See fn 47 for categories.
[46] Id.
[47] (i) A natural person who is a resident of the United States;
(ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of
the foregoing, in each case that is organized or incorporated under the laws of the United States;
(iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is exclusively for foreign employees of such entity;
(iv) An estate or trust, the income of which is subject to U.S. income tax regardless of source; or
(v) An individual account (discretionary or not) where the beneficial owner is a person described in (i) through (iv) above.
[48] *Final Exemptive Order Regarding Compliance with Certain Swap Regulations,* 77 C.F.R. ch. 1 (Dec. 21, 2012)

level requirements. The order also includes a definition of the term "US person"[49] which will apply for purposes of the order, and is similar to the criteria in the October 2012 no action letter. For transaction-level requirements under Dodd-Frank, non-US SDs, non-US MSPs, and foreign branches of US SDs or US MSPs, may, until the order expires in July 2013, comply with the transaction-level requirements of their local jurisdiction for swaps with non-US counterparties, provided that they comply with all transaction-level requirements under the Dodd-Frank Act for swaps with US counterparties.

From a policy perspective and with the intent to reinforce global communication efforts, "the Commission also recognizes the critical role of international cooperation and coordination in the regulation of derivatives in the highly interconnected global market, where risks are transmitted across national borders and market participants operate in multiple jurisdictions. Close cooperative relationships and coordination with other jurisdictions take on even greater importance given that, prior to the recent reforms, the swaps market has largely operated without regulatory oversight and many jurisdictions are in differing stages of implementing their regulatory reform. To this end, the Commission staff has actively engaged in discussions with their foreign counterparts in an effort to better understand and develop a more harmonized cross-border regulatory framework. The Commission expects that these discussions will continue as it finalizes the cross-border interpretive guidance and as other jurisdictions develop their own regulatory requirements for derivatives."[50] This is an important statement as it shows that, although the CFTC has its own set of rules in place, it will work to delay compliance until a workable solution is reached. Other jurisdictions do not have to act quickly to follow the leader and instead can work with the leader in coordinating an efficient regime, although it may mean adopting portions of the CFTC's rules or at least considering them as a starting point.

For purposes of the definition of a "US person," the order emphasized that the Commission views a foreign branch of a US person as a "US person." The CFTC notes that branches are "neither separately incorporated nor separately capitalized and, more generally, the rights and obligations of a branch are the rights and obligations of its principal entity (and vice versa)."[51] The order also provided for various registration and aggregation for de minimis calculation guidelines and conducted a cost benefit analysis

[49] For purposes of the Final Order, the Commission will treat as a "US person" any person identified by the following five criteria:
(i) A natural person who is a resident of the United States;
(ii) A corporation, partnership, limited liability company, business or other trust, association, joint-stock company, fund or any form of enterprise similar to any of the foregoing, in each case that is (A) organized or incorporated under the laws of a state or other jurisdiction in the United States or (B) effective as of April 1, 2013 for all such entities other than funds or collective investment vehicles, having its principal place of business in the United States;
(iii) A pension plan for the employees, officers or principals of a legal entity described in (ii) above, unless the pension plan is primarily for foreign employees of such entity;
(iv) An estate of a decedent who was a resident of the United States at the time of death, or a trust governed by the laws of a state or other jurisdiction in the United States if a court within the United States is able to exercise primary supervision over the administration of the trust; or
(v) An individual account or joint account (discretionary or not) where the beneficial owner (or one of the beneficial owners in the case of a joint account) is a person described in (i) through (iv) above.
The modifications made by the Commission to the counterparty criteria set forth in CFTC Letter No. 12-22 relate to (1) the location of an entity's principal place of business, (2) the treatment of pension plans for foreign employees, (3) the treatment of estates and trusts, and (4) the treatment of joint accounts Foreign Branch of US Person.

[50] Id. "This is one aspect of the Commission's on-going bilateral and multilateral efforts to promote international coordination of regulatory reform. The Commission staff is engaged in consultations with Europe, Japan, Hong Kong, Singapore, Switzerland, Canada, Australia, Brazil, and Mexico on derivatives reform. In addition, the Commission staff is participating in several standard-setting initiatives, co-chairs the IOSCO Task Force on OTC Derivatives, and has created an informal working group of derivatives regulators to discuss implementation of derivatives reform."

[51] Id.

relating to the final order as required by Section 15(a) of the CEA.[52] Consistent with its policy statement above, benefits included the added value of time and international harmonization: "In terms of benefits, the proposal stated that the exemptive order would provide a benefit in that it would allow affected entities additional time to transition into the new regulatory regime in a more orderly manner, which promotes stability in the markets as that transition occurs. Another benefit proposed was the increase in international harmonization because the proposed relief provided US and non-US registrants the latitude necessary to develop and modify their compliance plans as the regulatory structure in their home jurisdiction changes, which would promote greater regulatory consistency and coordination with international regulators." The relief provided to non-US SDs and non-US MSPs (and foreign branches of a US SD or MSP) expires on July 12, 2013. It is interesting to note that the CFTC's way of proceeding is counterintuitive and slightly aggressive. Rather than consulting international regulators in advance to develop agreed international standards, it proposes its own rules, then delays compliance for a fixed period which puts pressure on other regulators to conform to the US rules to avoid conflict.

ii. CFTC Statements. Commissioner Jill E. Sommers issued a statement of dissent from the final exemptive order.[53] Although she agreed with the concept of temporary relief, she did not agree with the approach used. Instead, she supports mutual recognition: "All G-20 nations have agreed to a comprehensive set of principles for regulating the over-the counter derivatives markets. Instead of recognizing these commitments and resolving to work towards mutual recognition of comparable regulatory regimes, keeping in mind the core policy objectives of the G-20 commitments, the Commission has embarked on a cross-border analysis that I fear is taking us down a path of regulatory detail that is overly burdensome, complicated, and unnecessary. I have consistently supported harmonization with both foreign and domestic regulators."[54] Sommers supports dialogue to choose a workable framework, for it is likely that the CFTC's delayed compliance approach, as noted above, may bring undue pressure on other jurisdictions to move their rules in the direction of those of the US to avoid conflict.

Scott O'Malia concurred with the order,[55] emphasizing coordination and limited extraterritorial reach. In this vein, he noted that between issuance and expiration, the Commission should do two things: "First...it should actively engage with other regulators. Second, the Commission should use the next several months to revisit and revise the grossly overbroad conception of extraterritorial reach [triggered by the definition of US person] that it argued for in the July proposed guidance. Most important, the Commission needs to articulate a clear, logical interpretation of the 'direct and significant' connection required by the statute as a prerequisite to applying our regulations to entities and activities abroad."

Gary Gensler issued a statement of support[56] for the order and highlighted the importance of international cooperation and coordination in the regulation of the highly interconnected global market. He notes that the Final Order reflects comments from foreign market participants and reflects an ongoing consultation with foreign regulatory counterparts. Gensler highlighted a December 4, 2012 joint press statement of market regulators, and agreed with its goals, namely to "meet regularly with foreign

[52] Id. Costs and benefits to be considered in five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations.
[53] Jill E. Sommers, Comm'r, US Commodity FuturesTrading Comm'n, *Dissenting Statement on Final Exemptive Order Regarding Compliance with Certain Swap Regulations* (Dec. 20, 2012).
[54] Id.
[55] Scott D. O'Malia, Chairman, US Commodity Futures Trading Comm'n, *Concurring Statement of Commissioner Scott D. O'Malia, Final Exemptive Order Regarding Compliance with Certain Swap Regulations (Cross-Border Exemptive Order)* (Dec. 21, 2012), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/omailastatement122112
[56] Gary Gensler, Chairman, US Commodity Futures Trading Comm'n, *Statement of Support on Final Exemptive Order Regarding Compliance with Certain Swap Regulations and Further Proposed Guidance (Final Order)* (Dec. 21, 2012).

regulators to consult on, among other topics, the basis for substituted compliance, timing and sequencing of rules, clearing determinations, and options to address potential conflicting, inconsistent, and duplicative rules."[57] The aforementioned statements demonstrate that the exemptive order was an effort by the CFTC to foster future conversations between global regulators and to potentially narrow the extraterritorial reach of the rules. They also reveal significant differences about next steps.

d. Other US domestic regulations.

Title VII's mandate to regulate derivatives extends to other US regulators as well to implement Dodd-Frank's objectives. Although the CFTC has been the most active, since *Examining the Extraterritorial Reach*, the Treasury, bank prudential regulators (such as the Federal Reserve Board and Office of the Comptroller of the Currency (OCC)) and SEC have taken regulatory initiatives as well.

i. <u>SEC Proposed Rules on Capital and Margin</u>. On October 17, 2012, the SEC voted unanimously to issue proposed rules for capital, margin, and segregation requirements for registered nonbank SBSD and nonbank MSBSP,[58] including those dually registered with the CFTC. SDs (or SBSDs) and MSPs (MSBSPs) that are banks do not have to register with the CFTC or the SEC and will only be subject to margin and capital rules established by US prudential regulators (an example of the fragmented US regulatory structure). The proposed rules did not give clear guidance on their extraterritorial application.

For example, for margin, SBSDs must collect margin from counterparties to uncleared security-based swaps to cover current exposure (variation margin, VM) and potential future exposure (initial margin, IM). Initial margin collection is not common and thus a point of contention for international regulators and bodies as will be described in Section IV below. Several proposals by the SEC are indeed consistent with the BCBS-IOSCO consultation paper on margin discussed in Section IV below, including several exceptions or alternatives for interdealer security based swaps such that no IM is required,[59] but other proposals are not aligned with the consultation.[60] Also, the proposal does not address an exception from margin for sovereigns or central banks whereas the BCBS-IOSCO paper recommends this exception. The CFTC's proposed rules on margin for uncleared swaps are described in depth in *Examining the Extraterritorial Reach*.

ii. <u>US Treasury</u>. In November 2012, the US Treasury exempted foreign exchange swaps from Dodd-Frank, because in its judgment, those swaps already contain high levels of transparency and risk management.[61] Foreign exchange swaps are particularly important, accounting for the second-largest source of derivatives trading revenue for US bank holding companies, according to the OCC. Commentary that moving FX swaps to clearinghouses would create additional costs for businesses and potentially increase systemic risk was applauded. It is important to note that exempt foreign exchange swaps and foreign exchange forwards do remain subject to the regulatory reporting requirements and

---

[57] Id.

[58] *SEC Proposes Security-Based Swap Capital, Margin and Segregation Rules*, Cleary Gottlieb Steen & Hamilton LLP (Oct. 17, 2012).

[59] Such as when thresholds are not met to require IM or when transacting with a commercial end user. Further, SBSDs would be required to collect variation, but not initial, margin in transactions with each other.

[60] Initial Margin would be a requirement for equity in the account calculated by applying the deductions required under the SBSD capital rule to the positions in the account. On the business day following each daily calculation, SBSDs would be required to collect eligible collateral from their counterparties in an amount at least equal to the variation margin in the account plus the margin amount (IM).

[61] Silla Brush, *US Treasury Exempts Foreign Exchange Swaps From Dodd-Frank*, Bloomberg, Nov. 16, 2012. See 77 Fed. Reg. 69,694 (Nov. 20, 2012). The exemption does not apply to financial products such as non-deliverable foreign exchange forwards, foreign exchange options or currency swaps.

external business conduct standards.[62] Primarily based on safety, the effort to exempt foreign exchange swaps from requirements is also beneficial from an international comity perspective in that derivatives based on the relationships between countries' currencies are viewed as safe and will not become an area of tension between nations.

iii. SEC Proposed Rules and Interpretive Guidance on Extraterritoriality. Significantly, on May 1, 2013, the SEC voted unanimously to issue proposed rules and interpretive guidance on cross-border security-based swap activities. Its proposal details which regulatory requirements apply when a transaction occurs partly within and partly outside the US. Regardless of location, the proposed rules would apply to transactions involving a person in the US engaged in counterparty-facing activity, regardless of whether the transaction is booked in a US-based or a foreign-based booking entity.[63] The proposed rules also describe when SBSDs, MSBSPs, and other entities must register with the SEC. The SEC takes a territorial approach to where the transaction occurs, not where booked, in deciding whether counterparties are or are not US persons.[64]

John Ramsey, acting director of the Division of Markets and Trading of the SEC, delivered a speech to the ABA[65] on May 15, 2013 and noted that the SEC's proposal primarily addresses (i) regulation of dealers and major swap participants, which includes both entity requirements such as capital and transaction requirements, including certain business conduct rules; (ii) registration of infrastructure entities (data repositories, clearing agencies and execution facilities); and what Mr. Ramsey views as (iii) "market-wide transaction requirements," which apply to dealers and non-dealers (i.e., regulatory reporting and trade dissemination, mandatory clearing requirements, and mandatory trade execution). According to Ramsey, "it may be best to understand the proposal by separating two main questions that are addressed. The first is whether particular entities or transactions are captured by the rules because there is a sufficient nexus to the US. The second question is how they comply with the rules when the tripwire is crossed. It is in answer to the second question that the idea of substituted compliance comes into play," isolating the proposals into two main components (i.e., are the extraterritoriality rules triggered and, if so, can substituted compliance be used?).

It is of note that substituted compliance would not be permitted for US SBSDs and that the Proposed Rules do not contemplate a substituted compliance regime for non-US MSBSPs but will consider substituted compliance for non-US MSBSPs based on comments received. Substituted compliance determinations would be made on class or jurisdiction basis (not firm-by-firm). A substituted compliance determination would apply to every non-US SBSD in the specified class or classes registered

[62] John Ramsay, Acting Dir., Div. of Trading and Mkts., US Sec. and Exch. Comm'n, *Cross-Border at the Crossroads: The SEC's "Middle Ground"* (May 15, 2013).
[63] Id. According to John Ramsey, "we have taken a 'territorial' and 'entity-based' approach. A key issue under that first heading is whether an entity is conducting enough business to require it to register as a dealer in security-based swaps, after considering the rules we've previously adopted requiring that an entity conduct more than a threshold amount of dealing activity to trigger registration. In answering that question, dealers located in the US consider all of the business they conduct, foreign and domestic. Also, consistent with the treatment of bank branches in other contexts, branches located overseas are considered part of the US entity they are attached to. In contrast, entities located off-shore count only the business they conduct within the United States or with US persons. In defining the term "US person," we took a simple, straightforward approach: US persons are residents, those that are incorporated or organized here, and those that have their principal place of business in the US."
[64] Id. John Ramsey explains why: "We proposed to treat transactions executed, solicited, negotiated, or booked in the US as US business because that reflects common sense and in order to level the playing field. Consider a scenario that reflects trades that happen every day. A bank based in the U.K. uses its New York mid-town office to negotiate and document a CDS trade with a German hedge fund. If this trade was not considered to be US business, a US dealer with offices in the very same building might have to operate under a very different set of rules if it did precisely the same trade with the same counterparty." This is an important point when deciding which cross-border rules apply and the choices are (i) US rules if a US person is involved, (ii) where the transaction occurs if using the SEC's guidance for substituted compliance or (iii) choice of parties.
[65] Id.

and regulated in the relevant jurisdiction. Last, it is important to emphasize that substituted compliance determinations come into play after an entity has registered under Dodd-Frank and there is no substituted compliance exemption for entity level requirements. [66] Ramsey also explained the context for the new rules, noting that the reality of the international derivatives playing field was considered.[67] He notes that the importance of the global G-20 commitments and that because much of derivatives trading have an international component, careful extraterritorial application is inevitable. The approach used by the SEC was to apply registration and other threshold requirements to activities that occur in the US, "but provide the ability to make broad substituted compliance determinations or grant exemptions to allow foreign firms to comply with home requirements, or to clear or execute trades through offshore facilities, where the foreign regimes aim at the same outcomes as ours."

Seemingly influenced by the CFTC, the proposal contemplates a substituted compliance framework in order to facilitate a well-functioning global security-based swap market.[68] Under the SEC's substituted compliance approach, a foreign market participant would be permitted to comply with the requirements imposed by its own home country if those requirements achieve regulatory outcomes comparable with the regulatory outcomes of the applicable provisions of Title VII. If the home country does not have any requirements that achieve comparable regulatory outcomes, substituted compliance would not be permitted and the foreign entity would be required to comply with the applicable US requirements.[69] The proposed substituted compliance would be based on regulatory outcome and not rule-by-rule comparison; the SEC would focus on "whether the foreign regime achieves regulatory outcomes that are comparable to the regulatory outcomes of Title VII rather than basing the ultimate determination on a rule-by-rule comparison." The SEC has categorized margin requirements as entity-level, which means they would apply to all transactions by the non-US SBSD, including transactions by its foreign branches with non-US persons, even though it acknowledges in the proposal that capital, margin and other entity-level requirements applicable to SBSDs have a substantial impact on the competitive position of firms operating in multiple jurisdictions. Further, although potentially eligible for substituted compliance for margin requirements, if the requirements of the home country of the a non-US SBSD are not deemed comparable by the SEC's substituted compliance standards, the non-US SBSD would be subjected to US margin requirements. The comment period for the proposed rules and interpretive guidance will last for 90 days after their publication in the Federal Register.[70]

---

[66] The SEC has given several reasons for this in its proposal, including that (i) registration enables SBSDs to notify the SEC that they are engaging in dealing activity above the de minimis threshold, (ii) registration is how non-US SBSD notify the SEC that they intend to seek substituted compliance and (iii) registration allows the SEC to maintain oversight over the industry. See fn 68.

[67] John Ramsay, Acting Dir., Div. of Trading and Mkts., US Sec. and Exch. Comm'n, *Cross-Border at the Crossroads: The SEC's "Middle Ground"* (May 15, 2013).

[68] US Securities and Exchange Commission, *Cross-Border Security-Based Swap Activities; Re-Proposal of Regulation SBSR and Certain Rules and Forms Relating to the Registration of Security-Based Swap Dealers and Major Security-Based Swap Participants*, available at http://www.sec.gov/rules/proposed/2013/34-69490.pdf

[69] In making the comparability determination, the SEC would separately assess four distinct categories of Title VII requirements. If, for example, a foreign regulatory system achieves comparable regulatory outcomes in three out of the four categories, then the SEC would permit substituted compliance with respect to those three categories, but not for the one, non-comparable category. In other words, the Commission is not proposing an "all-or-nothing" approach.
The four categories are:
Requirements applicable to registered non-US security-based swap dealers.
Requirements relating to regulatory reporting and public dissemination of security-based swap data.
Requirements relating to mandatory clearing for security-based swaps.
Requirements relating to mandatory trade execution for security-based swaps.

[70] Other highlights of the proposal include (1) when is a non-US person required to register with the Commission as a Security-Based Swap Dealer?, (2) Conducting the De Minimis Calculation (related to the 2012 CFTC and SEC joint rules), (3) Aggregating Transactions Involving Dealing Activity of Affiliates (related to the 2012 CFTC and SEC joint rules), (4) What regulatory requirements apply to a Security-Based Swap Dealer?, (5) Conducting the Threshold Calculations (related to the 2012

In determining whether there would be a comparable regulatory outcome, the SEC would consider the scope and objectives of the foreign requirements, as well as the effectiveness of the supervision of the enforcement authority of the relevant foreign financial regulator. The determination of supervision and effectiveness could be sensitive if the SEC finds that supervision is inadequate, reinforcing support for having assessment by a supranational body such as the FSB, as subsequently discussed in this paper. The SEC would also be required to enter into a supervisory and enforcement MOU or other arrangement with the relevant foreign financial regulatory authority or authorities under such foreign financial regulatory system. This requirement contemplates coordination with more than one authority and is consistent with the SEC's general approach to inter-country agreements discussed in *Examining the Extraterritorial Reach.* These MOUs should address oversight and supervision of applicable SBSDs under a substituted compliance determination.

Besides registration, Ramsey explains, the extraterritorial application of US rules also applied to various infrastructure entities such as clearing agencies, data repositories and swap execution facilities. "Clearing agencies could be subject to US rules if they have any US members, on the theory that US membership transfers the risk of the clearing house directly to US markets." The transaction requirements for clearing also would apply to trades where there is specific and identifiable US activity. Unlike equivalence (described in Section IV below), substituted compliance is not all or nothing but rather participants can request substituted compliance in key categories on a jurisdiction by jurisdiction basis; thus, it is a careful consideration of a subcategory of rules, determining whether safe cross-border transactions can occur without application of US rules initially intended to promote safety.

In comparison with the CFTC rules, which depend on whether the entity is a US person, the SEC's application of its proposed rules on extraterritoriality depends more on where the transaction takes place. For example, if a transaction between two foreign entities takes place in the US, it would be subject to SEC rules. The definition of US person for the SEC is then less crucial because its rules' application do not necessarily stem from the definition.[71] Since it is still used to determine registration requirements, the SEC's US person definition is important and is similar to the narrower definition adopted by the CFTC as part of its December 21, 2012 exemptive order.[72] Similarly, for a transaction to be considered with respect to registration, both the SEC and CFTC requested comment on the treatment of transactions by non-US persons with foreign branches of US persons. In contrast to the SBSD registration requirements, the SEC would not apply a territorial analysis in determining the positions to be included in MSBSP calculations.[73] Both the SEC and the CFTC would exclude inter-affiliate swaps from calculation as to whether an entity is considered MSPs and MSBSPs.[74]

CFTC and SEC joint rules), (6) Attribution of Guaranteed Positions, and (7) What regulatory requirements apply to a foreign Major Security-Based Swap Participant?

[71] The Proposed Rules define a US person as (1) any natural person resident in the United States; (2) any partnership, corporation, trust, or other legal person organized or incorporated under the laws of the United States or having its principal place of business in the United States; or (3) any account (whether discretionary or non-discretionary) of a US person. The US person definition includes all branches and offices of that person. However, a non-US subsidiary of a US person would be a non-US person, even if the non-US subsidiary's obligations are guaranteed by its US parent. See fn 68.

[72] Except that the SEC would (a) include as a US person those funds with a principal place of business in the US, (b) not include separate prongs for pension plans, trusts or estates and (c) exclude certain supranational organizations.

[73] Generally, the proposed approach would not require foreign major security-based swap participants to comply with the transaction-level requirements that are specific to major security-based swap requirements in their transactions with counterparties that are non-US persons.

[74] The SEC gives more leeway for branches of US banks to function abroad as well.

Further, in terms of process and standard for comparability requirements, the SEC considers fewer categories than the CFTC proposes to consider.[75] Comparability determinations for both the SEC and CFTC will be made on an individual requirement/category basis, rather than based on a foreign regime as a whole. While the SEC adopts broader categories, the SEC proposal indicates that SEC comparability determinations may be subject to conditions. Additionally, even after a substituted compliance determination has been made with respect to a regulatory requirement, the proposal would permit the SEC to modify or withdraw the determination after appropriate notice and opportunity for comment, which may lead to regulatory uncertainty. A foreign SBSD or group of foreign SBSDs would be permitted to file an application requesting that the SEC make a substituted compliance determination if the foreign financial regulatory authority or authorities under the relevant jurisdiction directly supervise such SBSD. Requesters would provide support as to why substituted compliance should be granted and such other supporting documentation as the SEC may request and in response, the SEC would have discretion whether to solicit public comment. Applications for comparability determinations by the CFTC would be made directly to it on behalf of a non-US person in connection with its application to register as a SD or MSP, but could be made by a single non-US person, a group of non-US persons from the same jurisdiction or a foreign regulator. The application must include all applicable legislation, rules and policies, and the CFTC may conduct an on-site exam, consult with the foreign regulator or request an opinion of counsel. The SEC does not appear to contemplate applications made directly by foreign regulators but the CFTC does; however, the SEC envisions negotiation of MOUs with foreign regulators. The CFTC also expects to enter into an MOU or similar arrangement with the foreign regulator specific to the context of supervising SDs and MSPs, including with respect to procedures for confirming continuing oversight activities, access to information, on-site visits and notifications and procedures in certain situations.

The SEC's outcome-based approach to employing substituted compliance applies to mandatory clearing as well. The SEC would exempt persons from the mandatory clearing requirement with respect to an SBS transaction submitted to a foreign clearing agency which is the subject of a substituted compliance determination by the SEC. However, the SEC expects that there are likely to be a small number of requests for substituted compliance given a small number of SBS clearing agencies and because the clearing agency registration regime already provides for a category of exempt SBS clearing agencies through which market participants may clear their transactions to satisfy the mandatory clearing requirement. It is closer to the G-20's goals of coordination explored in Section IV below; the SEC's philosophy is that exploring an outcome based approach is a more efficient way to achieve desired results. However, in the CFTC regime, all swap dealers would be subject to all transaction-level requirements regardless of location or outcome and only be eligible for substituted compliance with respect to mandatory clearing if a foreign clearing agency is determined to be comparably regulated, without specific regard to whether the clearing agency achieves any desired outcome. The biggest differences from CFTC proposals, however, are the SEC's proposal to allow substituted compliance for transaction-level rules for a security-based swap between a US person and a non-US person and the SEC's preliminary proposal to evaluate substituted compliance for entity-level rules on a more holistic basis.

It is important to note that there is potential for an added layer of regulatory mismatch, as a firm dealing in both types of swaps would have to register with both the CFTC and the SEC. Transaction-level CFTC rules would apply to swaps, and transaction-level SEC rules would apply to security-based swaps. Entity-level CFTC and SEC rules would apply to the firm as a whole, even where

[75] Categories include: capital, chief compliance officer, clearing and swap processing, daily trading records, margin and segregation for uncleared swaps, large trader reporting, portfolio reconciliation and compression, real-time public reporting, swap data repository reporting, risk management and other internal conduct standards, swap data recordkeeping, swap trading relationship documentation, trade confirmations and trade execution

duplicative. Not only could the agencies reach different results with result to substituted compliance, but foreign regulators would need to convince both agencies that home country rules are comparable. Also, substituted compliance determinations for margin and capital would not extend to banks, as the SEC and CFTC do not have the regulatory authority to establish capital and margin requirements for banks. The differences between the CFTC and SEC rules will add another layer of coordination necessary in making sure that compliance with one is neither more modest nor more burdensome than with another (as many foreign entities will be dual registrants under the CFTC and SEC regimes) and that data be collected for both swaps and security-based swaps markets so that it does not appear that rules are being evaded or that swaps are mischaracterized for purposes of the rules.

iv. <u>Prudential Regulators</u>. While this paper is not meant to survey the prudential regulator's (e.g., the Federal Reserve, OCC) proposals, it is important to note that the prudential regulators are an additional set of domestic regulators that have jurisdiction over OTC derivatives requirements (such as margin and capital (as described in the Collins Amendment[76])) with respect to US banking entities. For example, the prudential regulators are not only responsible for capital and margin requirements of national banks but also the foreign branches of national banks, and thus these rules have an extraterritorial element as well. For example, the OCC has proposed that US margin requirements would apply to all trades by such a foreign branch. In another example, the Fed is responsible for establishing capital and margin requirements for an SD that is a foreign bank. Consistent with its existing rules for foreign banks that have a US branch, the Federal Reserve proposed that foreign bank SDs may comply with home country Basel capital requirements. The Federal Reserve also proposed that a foreign bank, unlike a US national bank, does not have to comply with US margin rules for its swaps with foreign customers, thus limiting the extraterritorial reach of rules and also substituting certain requirements as long as international Basel standards are met.[77]

The Lincoln Amendment (which codifies Dodd-Frank's swaps push-out rule) will require that US banks push out swap dealing activity involving equity swaps, commodity swaps, non-investment grade credit default swaps, as well as any other credit default swap that is not cleared. Assuming that the Lincoln Amendment applies to a US bank's foreign branches, then it will force US banks to move that activity into an affiliate, even when trading in the EU. It is less clear whether a similar requirement applies to a foreign bank with a US branch. A foreign bank is technically subject to the push out requirement for its entire swap dealing activities. The requirement is generally read to apply only to the US branch, not the bank as a whole. There is an expectation that the Fed will also interpret the provision to place the US branch of a foreign bank on a level playing field with the US banks. The coauthors raise the issue of prudential regulators since the proposed rules, in addition to the Lincoln Amendment, add another layer of extraterritorial application to the banking sector.[78]

f. Policy themes: CFTC seems to be moving away from broad extraterritoriality, call for coordination

Apart from proposed rules and exemption orders indicating that the CFTC is moving in the direction of limiting the reach of the extraterritorial rules and delaying compliance to allow for coordination, the CFTC commissioners have issued multiple speeches and policy statements separate from their statements in the proposed orders or no-action letters explaining their respective positions.

---

[76] Section 171 of Dodd-Frank that establishes minimum risk-based capital and leverage requirements on a consolidated basis for insured depository institutions, their holding companies and non bank systemically important financial institutions (SIFIs).
[77] See generally Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 91, 275641 (May 11, 2011) (to be codified at 12 C.F.R. pt. 45), available at http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/html/2011-10432.htm
[78] The authors thank Colin Lloyd (CGSH) for this consideration.

While they emphasize that coordination is key, the level of generality of their statements doesn't provide much of a roadmap as to how coordination will be achieved.

On December 4, 2012, the CFTC released a joint press statement with leaders of the authorities for the regulation of the OTC derivatives markets in Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the United States on operating principles and areas of exploration in the regulation of cross-border OTC derivatives,[79] calling for international engagement. The press release followed a meeting by the leaders on November 28, 2012, where they discussed reform of the OTC derivatives market (as agreed to by the leaders at the G-20 Pittsburgh Summit in September 2009). Advocating coordination over harmonization, "it is clear that coordination among jurisdictions regarding the regulation of cross-border activities should facilitate the implementation of the objectives of the G-20 regulatory reform agenda for the OTC derivatives market. However, complete harmonization – perfect alignment of rules across jurisdictions – is difficult as it would need to overcome jurisdictions' differences in law, policy, markets and implementation timing, as well as to take into account the unique nature of jurisdictions' legislative and regulatory processes." While harmonization is unlikely, the commitment of countries to consult with each other prior to making final determinations on derivatives products is an important and rare move that reflects the need to coordinate for cross-border transactional issues.

Continuing with a commitment to share information and to enter into bilateral and multilateral agreements to ease cross-border transactions, "we recognize that entering into, and abiding by, supervisory and enforcement cooperation arrangements should facilitate effective coordination in implementing recognition, substituted compliance, and registration categories and exemptions approaches." Recognizing that the G-20 sought for key reforms by 2012, which are not yet in place, the gap in regulations spurs the need to work together. They also emphasized various areas of exploration: recognition, registration and substituted compliance and exemptions. "In permitting the use of substituted compliance, the authority must first determine that the entities are already subject to comparable regulation, supervision and comprehensive oversight of compliance, by virtue of the fact that: (i) the foreign regulation and oversight meet the same regulatory objectives; and (ii) the foreign regulator has the authority and means to support and enforce compliance by relevant foreign participants, intermediaries and infrastructures." Future discussions will have the goals of reaching a consultation process, identifying possible international standards for regulation and compliance, and supporting the efforts of the FSB in ensuring coordination with standard setting bodies. The coauthors believe that the goals of these discussions are essential to the substituted compliance determinations mentioned above as the two determinations that foreign regulators will make about regulations and compliance will lack structure and consistency if made piecemeal and without international oversight. As such, these discussions appear to recognize the need for an international framework to develop standards for assessing when substituted compliance should be adopted.

In a speech delivered on December 21, 2012 by Commissioner Bart Chilton on cross-border issues,[80] he stressed harmonization and sensible aggregation requirements by limiting scope of rules and coordination: "As we have set out to do from the beginning of the Dodd-Frank rulemaking process, we are cognizant of the need for regulators around the globe to harmonize rules to the extent possible in order to avoid market disruption and regulatory arbitrage." He listed three broad goals: (1) narrow the definition of US person so that our extraterritorial reach is not too broad, (2) provide sensible aggregation

[79] Press Release, US Commodity Futures Trading Comm'n, *Joint Press Statement of Leaders on Operating Principals and Areas of Exploration in the Regulation of the Cross-Border OTC Derivatives Market* (Dec. 4, 2012), *available at* http://www.cftc.gov/PressRoom/PressReleases/pr6439-12

[80] Bart Chilton, US Commodity Futures Trading Comm'n, Comm'r on Cross-border Issues, *Orchestrating Harmony* (Dec. 21, 2012) (transcript available at http://www.cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement122112)

requirements so that foreign banks won't automatically have to become US swaps dealers just because they do business with foreign affiliates of US banks and (3) provide for a phased-in compliance to July 2013 to allow time for other jurisdictions to implement derivative market reforms. The issues associated with not working towards goal two have materialized into reality as French banks struggled with US requirements as conflicting with France's own.[81] The issue was that French banks registering as swap dealers in the US would have to provide disclosure to the CFTC that would violate European privacy laws and French regulatory blocking statutes, which can lead to enforcement action. Lawyers at European banks say the CFTC has acknowledged the issue privately and are confident that the CFTC will not overreach, but this is unclear considering the EU's perception of the CFTC's recent aggressive moves to registered foreign players to comply with its rules.

Most recently, on May 22, 2013, six key senators wrote to the CFTC in an uncharacteristic move, urging the CFTC to implement cross-border derivatives rules under Dodd-Frank as proposed, although opposed by foreign regulators.[82] The letter noted that the agency "correctly proposed rules to bring many cross-border transactions that have a direct and significant effect on US commerce under its regulatory authority." They noted that the CFTC's strict proposed guidance "is critical to carrying out the full meaning" of the law. While the senators praised substituted compliance, they recommended strict limitations on its application. Finally, the senators called the SEC's proposed cross-border rules "inadequate" and encouraged that agency to "follow the CFTC's model." The coauthors believe that this letter is shortsighted and controversial. While the goal of Dodd-Frank is indeed to protect the financial markets of the US, Dodd-Frank also recognizes the desirability of an international framework for adopting substituted compliance, and this letter reflects an approach that could act as a setback to international derivatives discussions. It also sharply contrasts with the April 18, 2013 letter to Secretary Lew discussed below by certain foreign governments, which notes, "An approach in which jurisdictions require that their own domestic rules be applied to their firms' derivative transactions taking place in broadly equivalent regulatory regimes abroad is not sustainable."

IV. Global Issues and Responses, Conflicts in Extraterritoriality; Clearing

On the international front, numerous commentaries from regulators, governments and supranational groups have been aired about how to proceed in implementing G-20 goals. This section will discuss certain new issues in extraterritorial application of derivatives regulation not covered in the coauthors' *Examining the Extraterritorial Reach*. It will also discuss the live conflict with respect to clearing, proposed end-user exemptions and affiliated transactions, as well as survey supranational recommendations with respect to OTC derivatives coordination, and commentaries and proposals by foreign market players, governments and international organizations. Another conflict described in d. below is with respect to the requirement of initial margin (IM), endorsed by both the SEC and CFTC but strongly opposed by ISDA. This fundamental difference with respect to IM reflects a true conflict and highlights necessity for agreement on minimum standards or alternatives such as enhanced capital requirements to achieve comparable outcomes. If the SEC and CFTC are concerned about contagion, they are not likely to yield on IM unless the alternatives are robust. This section will also highlight key differences between EMIR and US law, which may lead to conflict when extraterritorial application of one country's laws reaches into another's jurisdiction. While this section discusses potential conflicts between the US and EU, the conflicts are illustrative of potential conflicts among all important financial markets regulating derivatives.

---

[81] Mike Kentz, *French Banks Struggle with Swap Conflicts,* Reuters, Nov. 9, 2012.
[82] Joint letter from Senators Sherrod Brown, Tom Harkin, Jeff Merkley, Carl Levin, Elizabeth Warren and Dianne Feinstein to Gary Gensler, Chairman, Commodities Futures Trading Comm'n, *Support for the CFTC's proposed rules implementing the cross-border swaps provisions mandated under Title VII of the Dodd-Frank Act* (May 22, 2013).

a. EMIR v. US

Since *Examining the Extraterritorial Reach* was published, comprehensive new EU and US measures to regulate OTC derivatives and central clearing have progressed. As mentioned previously, in the US, Title VII is the primary legislation to implement the G-20 requirements of derivatives regulation. In the EU, two pieces of legislation serve that purpose: EMIR with respect to clearing, reporting to trade repositories and risk mitigation requirements for uncleared derivatives, and proposed amendments to the Markets in Financial Instruments Directive (generally known as MiFID II/MiFIR) with respect to the trading obligations. The European Securities and Markets Authority (ESMA) is required to prepare technical standards to implement EMIR's requirements, which are key in defining its precise scope; these technical standards must then be endorsed by the European Commission (EC) and not objected to by the European Parliament and the Council of the European Union. EMIR applies to all segments of the derivatives market, including interest rate, credit, equity, foreign exchange and commodities.[83] EMIR entered into force in the EU on August 16, 2012; however, at the time of writing, only certain of EMIR's risk mitigation obligations have come into force.[84] For capital and margin requirements, EMIR requires financial and certain non-financial counterparties whose derivatives activities exceed various thresholds (NFCs) to exchange collateral, and it also requires financial counterparties to hold enough capital to manage risk not covered by such collateral. Of note, on June 6, 2013, ESMA published an updated set of frequently asked questions relating to the implementation of Regulation 648/2012 on OTC derivatives, central counterparties and trade repositories. The FAQs are intended to promote common supervisory approaches and practices in the application of EMIR. While they are aimed mainly at Member State competent authorities, they also clarify some aspects of the application of EMIR for market participants.

ESMA published its technical standards and final report on EMIR in September 2012.[85] At present, it is expected that the clearing obligation will apply from mid-2014 for financial counterparties.[86] The EC has stated that the clearing obligation for NFCs will be subject to a three year phase-in period. However, since the publication of the technical standards on risk mitigation techniques on exchange of collateral and extraterritorial provisions has been delayed,[87] it will be some time before the industry will be in a position to be able to identify which extraterritorial contracts should be cleared, as well as to begin to exchange segregated collateral on uncleared contracts. However, making some progress in February 2013, there was a final sign off on a number of EMIR's technical standards. The technical standards passed determine (inter alia) margin requirements for cleared derivatives and the approach for deciding which classes of derivatives should be cleared.[88] EMIR's mandatory clearing obligation will apply extraterritorially to derivatives contracts entered into between an EU and a non-EU counterparty that would be subject to mandatory clearing if the non-EU counterparty were established in the EU. EMIR's risk mitigation obligations will also apply extraterritorially (i) to derivatives contracts entered into between an EU and a non-EU counterparty (although the extent to which the non-EU counterparty will be subject to these obligations is as yet unclear), and (ii) to derivatives contracts entered into between two

---

[83] Sebastian Sperber, David Toube, Colin Lloyd, Sebastian Cameron, *Derivatives Regulation — US/EU Developments*, Cleary Gottlieb Steen & Hamilton LLP (Sep. 26, 2012).

[84] Further risk mitigation requirements are expected to come into force in September 2013, and reporting to trade repositories is expected to come into force in November 2013 at the earliest.

[85] Kirsty Gibson, *EMIR Update — ESMA Publishes Finalised Technical Standards*, Linklaters LLP (Oct. 2012)

[86] Kirsty Gibson, *EMIR Update — ESMA Publishes Finalised Technical Standards*, Linklaters LLP (Oct. 2012) See ESMA's EMIR timeline, *EMIR indicative timeline – Last update: 22-May-13*, available athttp://www.esma.europa.eu/page/European-Market-Infrastructure-Regulation-EMIR

[87] ESMA is now expected to submit technical standards relating to extraterritoriality by September 2013, see http://www.esma.europa.eu/system/files/2013_04_17_letter_jf_to_esma-rts_art_44_and_1114.pdf

[88] *EMIR Delay Avoided with last-ditch deal*, Asset International, Inc. (1989-2012), available at http://www.thetradenews.com/print.aspx?id=6442451474. They also implement the regulatory framework for CCPs and trade repositories, risk mitigation requirements for uncleared derivatives and reporting requirements.

non-EU counterparties "provided that those contracts have a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provision" of EMIR.[89] This language is almost identical to that used in Dodd-Frank granting power to the CFTC and the SEC to give extraterritorial effect to its new rules and was likely influenced by the Act's wording.[90] Derivatives contracts between an EU and a non-EU counterparty are also subject to EMIR's reporting obligation, although it is expected that only the EU counterparty will be required to comply with the reporting obligation.

It is worth noting that EMIR contains a provision (described as a "mechanism to prevent duplicative or conflicting rules"), which provides that where one party to a transaction is established outside the EU and is subject to a regime declared "equivalent" to EMIR, the parties will be deemed to comply with EMIR's clearing and reporting obligations if they satisfy such requirements in the "equivalent" jurisdiction. This deemed equivalence is however conditional upon the EC adopting an implementing act on the equivalence of the non-EU regime;[91] interestingly, no such acts have been adopted to date. This point is important, as it appears that the mechanism by which equivalence can be determined in Europe is formal, and thus will not be a simple determination whose goal is to enable the flow of cross-border transactions. Very little has been said about this mechanism by the EC or ESMA to date, although there has been a Formal Request to ESMA from the EC, which requests ESMA to provide advice on the equivalence of various third country regimes, including the US.[92] However, nothing has yet been released publicly on equivalence of any particular jurisdictions,[93] although given that many cross-border US rules come into play in July 2013, the EC has asked ESMA to produce technical advice on equivalence of the US regime by mid-June 2013 (with other major jurisdictions following a month later). It is of note that the EU approach of equivalency (similar to mutual recognition) is based on reciprocity, which creates tension in that a bilateral conclusion needs to occur for equivalence to apply. Substituted compliance does not rely on equivalency. Instead a point of tension in substituted compliance is: if one country grants substituted compliance with a host country's rules, the host country may not reciprocate. This can thereby create the reverse conflict that reciprocity creates in the EU's equivalence regime.

Dodd-Frank and EMIR differ in key respects. The application of the clearing obligation to non-financial institutions, registration requirements for dealers, rules on margin and collateral, registration requirements for clearinghouses, exchange trading and reporting requirements are all areas of difference. However, "to ensure that CCPs active in the EU can continue to provide services in the transitional period between the entry into force of the adopted technical standards and the recognition of the relevant third-country CCP under EMIR, those CCPs will be permitted to operate subject to existing national regimes until they have been recognized under EMIR. EMIR's provisions seeking to avoid duplicative or conflicting rules and the CFTC's proposal for 'substituted compliance' are helpful, but regulators on both sides of the Atlantic still need to take formal steps to avoid market fragmentation."[94] This supports the argument that substituted compliance frameworks will need to be developed in a multilateral framework or else conflicts will fragment markets.

---

[89] Article 11(12) of EMIR.
[90] See fn 18.
[91] See EMIR Article 13(3).
[92] The European Commission has requested technical advice with respect to the equivalence of the regimes in the US, Japan, Hong Kong, Switzerland, Canada and Australia.
[93] John Rega, *Resolution authorities will get wide power for clearinghouses in EC proposal* (May 23, 2013).
[94] *OTC Derivatives Regulation and Extraterritoriality III*, Fin. Insts. Advisory & Fin. Reg. (Shearman & Sterling LLP) (Feb. 8, 2013).

b. Central clearing – example of conflict

i. General. On December 12, 2012, Gary Gensler testified before the US House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises, Lowering Risk and Democratizing the Market through Clearing. He noted that central clearing was the first building block of Dodd-Frank reform and lowers the risk in an interconnected financial system. Due to its importance, both the US and EU have been active with respect to clearing requirements. In the US, to clear a swap, counterparties subject to mandatory clearing will submit respective sides to a derivatives clearing organization (DCO) rather than establishing a bilateral contract. The two counterparties to a cleared swap are not required to, but may, use the same clearing broker to clear the swap.[95] Cleared swaps are subject to margin requirements established by the DCO, including daily exchanges of cash variation (or mark-to-market) margin and an upfront posting of cash or securities initial margin to cover the DCO's potential future exposure in the event of its default. The Commodity Exchange Act authorizes the CFTC to require a category of swaps to be cleared by a DCO. On November 28, 2012, the CFTC issued its first mandatory clearing determination for certain interest rate swaps[96] (only in US Dollars, Euro, Sterling or Yen) and credit default swaps, planning to make additional clearing determinations in the future. There are certain exemptions and exceptions for inter-affiliates trades and end users explored in this Section.

As discussed above, under EMIR, the clearing obligation is expected to apply generally to certain transactions to which two qualifying EU entities are party, but it will also apply to transactions between a financial counterparty or a NFC and a non-EU entity that would be subject to the clearing obligation if the counterparty were established in the EU (i.e., an entity which would, if established in the EU, be classed as a financial counterparty or a NFC). For example, this provision may operate to impose EMIR's clearing obligation on a transaction between an EU financial institution and a non-EU financial entity or an end-user established outside the EU which engages in substantial speculative derivatives activities.[97] For transactions between two non-EU entities, EMIR's clearing obligation will also apply "provided that the contract has a direct, substantial and foreseeable effect within the EU or where such obligation is necessary or appropriate to prevent the evasion of any provisions" of EMIR.[98] The provisions of EMIR applicable to CCPs are silent as to territorial scope. However, a counterparty can only satisfy EMIR's clearing obligation by clearing through an EU CCP which has been authorized by the competent authority of an EU member state, or a non-EU CCP which has been recognized by ESMA. Likewise, under MiFID II/MiFIR, trading derivatives classes on non-EU trading venues are not expected to satisfy MiFID II/MiFIR requirements unless the non-EU trading venue is located in a jurisdiction deemed to have equivalent provisions to those of EMIR.

The requirement for central clearing, the cornerstone of international derivatives reform as discussed above, is an area of potential conflict between EU and US law and may result in duplicative/conflicting regulation and sets of requirements. Under Dodd-Frank, swaps that must be cleared through a DCO cannot also clear under an EU-registered trading platform unless the transaction is cleared on a platform that is approved under both US and EU regulations. EMIR creates a mechanism for recognizing third-country CCPs for purposes of satisfying the clearing obligation. Under EMIR's recognition regime, ESMA may recognize a CCP established in a non-EU country if three conditions are met: (i) the CCP is authorized in the relevant third country and is subject to effective supervision and enforcement, ensuring full compliance with the prudential requirements applicable in that third country,

---

95 A counterparty clears either as a self-clearing member of the DCO or through an FCM (futures commission merchant) that is a member of the DCO and acts as the counterparty's broker.
96 Such as fixed-to-floating swaps, floating-to-floating swaps (basis), forward rate agreements and overnight indexed swaps.
97 The authors thank Sebastian Cameron (CGSH) for this contribution.
98 Article 4(a)(iv) and (v) of EMIR.

(ii) the relevant jurisdiction has been deemed equivalent by the Commission,[99] and (iii) the relevant third-country competent authority has agreed adequate supervisory cooperation agreements with ESMA. Third-country CCPs will not be subject to EMIR, but to the equivalent requirements of the country in which they are established and regulated. EMIR gives ESMA discretion in the recognition process by mandating that ESMA may recognize third-country CCPs that satisfy the above criteria. Dodd-Frank authorizes the CFTC and SEC to exempt comparably regulated non-US CCPs from registration in the United States, and permits satisfaction of its clearing obligation by clearing through such an exempt non-US CCP.[100] EMIR requires each EU member state to delegate regulatory authority over a CCP to a competent authority, which will be responsible for the supervision of home-country CCPs and may impose additional requirements on them. Therefore, EMIR and the ESMA final technical standards only set forth minimum standards that may be further developed by a member state's competent authority. [101] However, as EMIR is a regulation and therefore directly applicable in each EU member state, there is likely to be only limited discretion for individual member states to impose additional requirements, particularly in relation to areas directly addressed by EMIR. Furthermore, if a member state does decide to impose additional requirements on CCPs established in that member state, this should not prejudice the right of CCPs established in other member states to provide clearing services in that member state without complying with such additional requirements.[102]

There is an added element of uncertainty regarding the regulation and supervision of EU CCPs and US DCOs and determinations with respect to equivalence.[103] Pursuant to Title VIII of Dodd-Frank, FSOC recently designated the largest US DCOs as systemically important financial market utilities (e.g., CME, Options Clearing Corporation, ICE, and the DTCC). This gives the Federal Reserve Board power to supervise and impose additional regulations on these DCOs and provides these DCOs with access to Federal Reserve liquidity. EMIR contemplates that CCPs may have access to central bank liquidity but it does not mandate that central banks provide such liquidity. In fact, one aspect on which the Commission is required to report to the Parliament and Council in 2015 is whether there is any need to introduce measures to facilitate the access of CCPs to central bank liquidity facilities.[104] Further, Title II of the Dodd-Frank Act sets forth the Orderly Liquidation Authority, which allows the FDIC to temporarily guarantee debt of a failing systemically important financial institution. Possibly, if a systemically important financial market utility were failing, regulators might attempt to subject the DCO to an OLA

---

[99] I.e., the legal and supervisory arrangements of the jurisdiction in which the non-EU CCP is established are equivalent to the requirements laid down in EMIR, and the jurisdiction has equivalent systems for anti-money laundering and combating the financing of terrorism to those established in the EU. Article 25(2)(a) and (d) of EMIR.

[100] Information about EMIR and European Derivatives regulations was obtained to a large extent from: see generally CLEARY, GOTTLIEB, STEEN & HAMILTON LLP, FINANCIAL REGULATORY REFORM IN THE EUROPEAN UNION: STATE OF PLAY AND PROSPECTS (2011). See also Chapter 7 of the 2012 Special Report to *U.S. Regulation of the International Securities and Derivatives Markets*, 10th ed., by Edward F. Greene, Alan L. Beller, Edward J. Rosen, Leslie N. Silverman, Daniel A. Braverman, Sebastian R. Sperber and Nicholas Grabar (Wolter Kluwer Law & Business 2012).

[101] Letter from R. Glenn Hubbard, Co-Chair, et al., Comm. on Capital Mkts. Reg. to Rodrigo Buenaventura, Head, European Sec. and Mkts. Auth., et al., *European Union and United States Need to Resolve Differences Between Their Clearinghouse Requirements* (Jan. 28, 2013).

[102] Recital (50), EMIR.

[103] Id. There are also key differences between the EU and US's clearing requirements. "For example, the ESMA final technical standards do not require EU non-financial counterparties (NFCs) to clear any swaps unless they exceed certain €1-3 billion thresholds for speculative swaps. If an EU NFC exceeds the threshold for any type of speculative swap, it must clear all swaps, including swaps for hedging purposes. Alternatively, the US regime requires NFCs to clear all speculative swaps but does not require US NFCs to clear swaps for hedging purposes under any circumstances. Furthermore, the US Treasury has exempted FX swaps from the definition of swaps (and thus any of the clearing and margin requirements applicable to swaps) while the ESMA technical standards do not exempt FX swaps from the clearing obligation and require EU NFCs to clear speculative FX swaps above a certain threshold." Another difference is that ESMA final technical standards do not require EU non-financial counterparties to clear swaps unless they exceed €1-3 billion thresholds for speculative swaps. This can cause international firms to divide their portfolios in different clearinghouses, leaving to fragmentation and reduced safety and efficiency.

[104] See EMIR Article 85 and EMIR Recital (71).

receivership. The EU regime does not yet include an orderly resolution process for CCPs. Comments from the EC suggest that development of such a framework will be a priority going forward. It might also be worth noting that some jurisdictions (e.g., the UK and Germany), are out in front of other European authorities by developing national CCP resolution mechanisms.[105]

In light of the differences between the EU and US requirements for CCPs, the SEC, the CFTC, the EC and the ESMA must work together to ensure that recognition of each clearinghouse regime is workable under a substituted compliance regime. Otherwise, the EU-US cross-border swaps market may be fragmented, which will result in increased risk. At the June 2012 Los Cabos Summit, the G-20 Leaders agreed that substantial progress had been achieved for an efficient global framework for central clearing. Given that progress, G-20 leaders called on jurisdictions to rapidly finalize their decision making to enact legislation and regulations to meet commitments to central clearing. The FSB is monitoring and will separately report on the steps taken in this regard. As mentioned above, foreign recognition for clearing is currently in place in certain EU member states.[106] However, third-country CCPs which are already recognized under the national law of an EU member state are required to apply for recognition under EMIR by September 2013. If they do not apply for recognition by this date, they will not be able to offer clearing services to clearing members and trading venues established in the EU.[107]

However, while there is an ability to avoid conflicting rules, those who do not qualify for exemptions may be subject to two differing sets of requirements depending on where they clear the transaction. For example, the ESMA final technical standards and CFTC Final Rule on DCO Core Principles impose different minimum standards for clearinghouse margin requirements, including different confidence intervals and holding periods.[108] The two regimes also differ in clearinghouse membership, clearing requirements and minimum financial requirements. Although not finalized, the CFTC proposed requiring systemically important DCOs to maintain enough financial resources to withstand a default by the two clearing members posing the largest combined financial exposure. In addition to differences in reporting and risk mitigation requirements, other key differences in relation to the clearing obligation include segregation requirements for collateral for cleared swaps, interoperability requirements with other CCPs and requirements relating to the resources which a CCP must employ to manage defaults of its clearing members. As a general matter, EMIR's technical standards applicable to CCPs are also much more detailed and prescriptive than the equivalent requirements under Dodd-Frank. Thus, if the CFTC mandates that swaps by US persons must be cleared in a CFTC-registered clearinghouse, and EMIR mandates that swaps by EU persons must be cleared in an EU-authorized or registered clearinghouse, then, even if the EC were to find that an EU person trading with a US person can satisfy the EMIR mandate by complying with CFTC rules, the EU person will still use the EU clearinghouse for its trades with other EU persons. That would lead to one portfolio in a US clearinghouse and another in an EU clearinghouse. One practical way to address this issue is for clearinghouses to register in multiple jurisdictions, which is increasingly becoming the case (LCH and ICE Clear Europe are key examples); however, there is significant inefficiency to dual registration explored below. Conflicting mandates raises the question of how multiple regulators will coordinate their

---

[105] Speech by Patrick Pearson of the European Commission to the AFME Annual European Post-Trade Conference, May 23, 2013.

[106] Letter from R. Glenn Hubbard, Co-Chair, et al., Comm. on Capital Mkts. Reg. to Rodrigo Buenaventura, Head, European Sec. and Mkts. Auth., et al., *European Union and United States Need to Resolve Differences Between Their Clearinghouse Requirements* (Jan. 28, 2013). According to EMIR, the European Commission will determine whether the US clearinghouse regime is equivalent to the EU regime.

[107] See, for example, Practical guidance for the recognition of Third Country CCPs by ESMA, European Securities and Markets Authority, Mar. 12, 2013, at para 9, available at http://www.esma.europa.eu/system/files/tc-ccp_applications.pdf.

[108] Id.

regulation over clearinghouses over which they share jurisdiction while still remaining faithful to their own country's financial system and uniqueness.[109] As of yet, no CCPs have been authorized or recognized under EMIR, and so it is not yet clear how "compatible" the EMIR and Dodd-Frank CCP regimes will prove in practice for dual-registered CCPs.

Dual registration may lead to fragmentation with differing requirements applying to the same entities. For example, LCH currently clears more than 50% of the interest rate swap market, with 2.5 million trades adding to an aggregate notional principal amount of $380 trillion. The benefits to concentrating open interest for interest rate swaps at LCH are clear for the entire market. The benefits include potential for multilateral netting. For an individual market participant, that netting leads to reduction in initial margin requirements; for a clearing member, it leads to a reduced guaranty fund contribution. As such, US to EU interest rate swaps have three main possibilities: (1) Both the CFTC and ESMA require interest rate swaps to be cleared at a locally registered clearinghouse, and LCH registers in the EU but not the US. EU market participants could therefore clear at LCH, but US market participants would have to clear at a US clearinghouse such as CME. Because there is no interoperability between LCH and CME, the market would fragment and there would be no US to EU interest rate swaps. (2) Both the CFTC and ESMA require interest rate swaps to be cleared at a locally registered clearinghouse, and LCH registers in the EU and the US. For a US to EU trade, both parties could clear at LCH, but LCH would need to comply with both sets of rules (which is impossible, since some of the rules, such as segregation requirements, are inconsistent with each other). (3) The CFTC continues to require that interest rate swaps be cleared at a CFTC-registered clearinghouse, but ESMA allows cross-border interest rate swaps to be cleared at a non-EU clearinghouse that is comparably regulated, such as the CME. In this case, an EU market participant could clear an interest rate swap with a US market participant at the CME, but would still need to clear its rate swaps with other EU market participants at LCH. This would require it to split its portfolio across CME and LCH, thereby reducing the netting benefits described above.[110] It is possible to address these fragmentation issues by taking an approach similar to what the SEC has proposed, whereby it would allow market participants to clear through a clearing agency wherever located that is either registered, exempt from registration, or neither registered nor exempt but determined by the SEC to be subject to comparable regulation in a foreign jurisdiction.

ii. Substantive Clearing Dialogue. On January 28, 2013, the Committee on Capital Markets Regulation urged derivatives regulators worldwide to cooperate and resolve differences in their proposed regulatory schemes in order to avoid an inefficient marketplace.[111] The Markets Division of ESMA, and the Financial Markets Infrastructure Unit of the EC compared the two sets of regulations in the US and the EU for the OTC derivatives market and observed "significant differences" between proposed regulations, as noted in a letter to the SEC by the Committee. For example, the letter stated that the CFTC's proposed guidance on cross-border derivatives rules would require swaps transacted between US and foreign parties to be cleared by a CFTC-registered clearinghouse (DCO). The proposed European Market Infrastructure Regulation (EMIR), however, would require swaps between EU and foreign parties to be cleared by an ESMA-recognized clearinghouse (CCP). "If the conflicting requirements of the CFTC proposed guidance and EMIR is left unresolved, separate clearinghouses will necessarily develop for swaps between EU counterparties and swaps between US counterparties, thus reducing netting

---

[109] The authors thank Colin Lloyd (CGSH) for this consideration.
[110] The authors thank Colin Lloyd (CGSH) for this set of possibilities.
[111] Letter from R. Glenn Hubbard, Co-Chair, et al., Comm. on Capital Mkts. Reg. to Rodrigo Buenaventura, Head, European Sec. and Mkts. Auth., et al., *European Union and United States Need to Resolve Differences Between Their Clearinghouse Requirements* (Jan. 28, 2013).

opportunities for each class of swap and resulting in unnecessarily burdensome collateral requirements for market participants."[112]

The letter envisions two solutions: "dual registration" or "foreign recognition."[113] However, as the more stringent requirements of each regime would apply to dually registered clearinghouses, these clearinghouses would impose more burdensome clearing requirements on their members than clearinghouses registered in only one jurisdiction. However, foreign recognized clearinghouses (already in place in certain EU member states) would only be subject to their home country's clearinghouse requirements. Market fragmentation and reduced netting opportunities may result if certain EU or US clearinghouses choose to forego dual registration in order to offer members less burdensome clearing requirements. Further, although EU clearinghouses are able to register with the CFTC, for example LCH.Clearnet and ICE Europe, EMIR does not allow foreign clearinghouses to register by the standard process applicable to EU clearinghouses (however, non-EU CCPs can be recognized under EMIR). Thus, US clearinghouses would be unable to clear EU-US cross-border swaps, or swaps between EU persons, while EU clearinghouses, registered with the CFTC, would be able to clear EU-US cross-border swaps and swaps between US persons.

Both the CFTC and ESMA have the authority to grant recognition of a foreign clearinghouse regime. Dodd-Frank authorizes the CFTC to recognize foreign clearinghouses that are subject to "comparable, comprehensive supervision and regulation" by their home authorities. EMIR authorizes ESMA to recognize foreign clearinghouses if the foreign regime imposes "legally binding requirements which are equivalent to" EMIR's requirements for EU clearinghouses. The Committee on Capital Markets Regulation prefers recognition to dual registration. "Most importantly, foreign recognized clearinghouses would only be subject to their home country's clearinghouse requirements. Thus, unlike dual registration, clearinghouses that clear EU-US cross-border swaps would not be required to impose the most stringent clearing requirements of either regime on their members. Foreign recognition would thus solve for the issues of market fragmentation and reduced netting opportunities. Furthermore, clearinghouses would not be forced to undertake the burdensome and duplicative process of registering with multiple regulatory authorities." The Committee on Capital Markets Regulation recommends that the EC and the CFTC work together to resolve the key differences between the two clearinghouse regimes so each can recognize the other regime's clearinghouses.

c. End users and affiliated transactions

Another potential conflict with the EU is with respect to requirements applicable to end user/affiliated transactions. A category of transacting entities called end users[114] have a limited exemption to the requirement to submit swaps for clearing and to execute swap trades on registered

---

[112] Id.

[113] Dual registration would involve registration of an EU clearinghouse with the CFTC and of a US clearinghouse with the ESMA, subjecting a dually registered clearinghouse to both EU and US clearinghouse requirements. Where differences between the two regimes persist, a dually registered clearinghouse would comply with the more stringent requirements of either regime. A dually registered EU clearinghouse could clear EU-US cross-border swaps and swaps between US persons; similarly, a dually registered US clearinghouse could clear EU-US cross-border swaps as well as swaps between EU persons.

[114] An end user is an entity that is not a financial entity, uses swaps to hedge or mitigate commercial risk and has notified the CFTC or SEC how it generally meets its financial obligations associated with entering into noncleared swaps. Dodd-Frank divides end users into two broad categories: financial and non-financial end users. An end user is a financial end user if it is a commodity pool, private fund employee benefit plan, or person that is predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956. The end-user exception provides that an affiliate of a non-financial end user may be permitted to use the exception so long as it acts "on behalf of the non-financial end user and as an agent.

exchanges. If one party is an end user, the swap does not need to be cleared.[115] The CFTC issued final rules detailing (i) an exception to the mandatory clearing requirement for non-financial end users and (ii) an exemption to the mandatory clearing requirement for transactions between certain affiliated entities.[116]

d. Commentary from market players, foreign governments and international organizations, conflict with respect to initial margin requirements

i. Policy. Many European and Asian foreign regulators issued individual or joint letters to the CFTC to limit the scope of its extraterritorial rules. Given that the SEC proposals were released in May 2013, there has not yet been significant public comment on the proposals from foreign regulators or market participants. On August 24, 2012, Jonathan Faull[117] of the EC wrote to the Secretary of the CFTC about the proposed interpretive guidance and exemptive order published by the CFTC on July 12, 2012 discussed above. In addition to the fact that definition of US person is too broad, according to the letter, the EC believes there will be significant risk attached to the proposed approach of duplicative requirements, which would lead to distortive and discriminatory outcomes.

The financial regulators of the Asia Pacific region wrote to Gary Gensler on August 27, 2012[118] concerning proposed guidance on cross-border application of certain swap provisions. While they took comfort with the proposed guidance of the CFTC and its effort to limit the impact of extraterritorial application of the rules, the regulators still had concerns with implementation: "We are concerned that some of the proposed requirements as they currently stand may have significant effects on financial markets and institutions outside of the US. We believe a failure to address these concerns could have unintended consequences, including increasing market fragmentation and, potentially, systemic risk in these markets, as well as unduly increasing the compliance burden on industry and regulators." In addition to reassessing the proposed guidance to consider outcomes versus using a rule-by-rule approach, the writers ask for more clarity in the definition of substituted compliance (namely how comparability will be assessed). For determining substituted compliance comparability measures,[119] "we are of the view that one useful point of reference for substituted compliance assessment would be the foreign regime's compliance with applicable global standards set by international standard-setting bodies like the CPSS, IOSCO and the Basel Committee on Banking Supervision works for minimum standards."[120] To assess

[115] If an entity is a US person, Dodd-Frank rules will differ if it is also an end user. Certain additional sub-categories apply in certain circumstances: In relation to the margin rules for non-cleared swaps, whether the client is a swap entity, high-risk financial end-user, low-risk financial end-user or non-financial end-user.

[116] See *Clearing Exemption for Swaps Between Certain Affiliated Entities*, CFTC, http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister040113.pdf (last visited Apr. 2, 2013). For the latter category, the CFTC has issued rules that exempt from mandatory clearing swaps between affiliated entities under common majority ownership and whose financial statements are consolidated with each other, whether or not such entities qualify as non-financial end users or use swaps to hedge or mitigate commercial risk. Affiliates are eligible for this exemption if one counterparty directly or indirectly holds a majority ownership interest in the other counterparty or if a common entity directly or indirectly holds a majority ownership interest in each counterparty.

[117] Letter from Jonathan Faull, Dir. Gen., European Comm. Directorate Gen. Internal Mkt. and Servs to David Stawick, Sec., Commodities Futures Trading Comm., *Comment letter proposed CFTC rules* (Aug. 24, 2012).

[118] Letter from Belinda Gibson, et al. to Gary Gensler, Chairman of Commodity Futures Trading Comn'n., *CFTC's Proposed Guidance on Cross-Border Application of Certain Swap Provisions of Commodity Exchange Act ("Proposed Guidance"* (Aug. 27, 2012).

[119] Given the small size of some of its markets, and the fact that US SDs provide liquidity for these markets, they ask the CFTC to consider this: "Certain US SDs operating in the Asia Pacific region are major liquidity providers in local markets. If they are not allowed to use clearing platforms other than DCOs that are US-registered or exempt from registration, and other smaller local / regional players can only access central clearing indirectly, the overall capacity of these players to further provide liquidity in local / regional OTC derivatives markets may be curtailed."

[120] Letter from Belinda Gibson, et al. to Gary Gensler, Chairman of Commodity Futures Trading Comm'n., *CFTC's Proposed Guidance on Cross-Border Application of Certain Swap Provisions of Commodity Exchange Act ("Proposed Guidance")* (Aug. 27, 2012).

comparability for substituted compliance with compliance with international standards is essential to avoid fragmented markets. However, new standards for the transactions relevant to Dodd-Frank, such as swaps clearing and OTC derivatives, would have to be written in order to implement substituted compliance, as opposed to complying with measures in place not tailored to these markets.

The commitment to work together was stressed in an initial joint Europe/Japan letter[121] from the Chancellor of the Exchequer UK Government, Minister of State for Financial Services Government of Japan, Commissioner for Internal Market and Services EC, and Minister of Finance Government of France to Gary Gensler of the CFTC on October 17, 2012: "We would urge you before finalising any rules, or enforcing any deadlines, to take the time to ensure that US rulemaking works not just domestically but also globally. We should collectively adopt cross-border rules consistent with the principle that equivalence or substituted compliance with respect to partner jurisdictions, and consequential reliance on the regulation and supervision within those jurisdictions, should be used as far as possible to avoid fragmentation of global markets. Specifically, this principle needs to be enshrined in CFTC cross-border rules, so that all US persons wherever they are located can transact with non-US entities using a proportionate substituted compliance regime." This letter stresses coordination between rules and cooperation through the lens of substituted compliance. It is important to note that it is unusual for foreign governments to submit public letters to US rulemakers. However, these public statements are a reflection of the importance of the cross-border derivatives markets and a reaction to the unilateral moves by the CFTC in proposing rules prior to other jurisdictions.

Similarly, in a statement by Masamichi Kono, Vice Commissioner for Internal Affairs, Financial Services Agency of Japan before the Subcommittee on General Farm Commodities and Risk Management of the US House on December 13, 2012,[122] he emphasized a need to avoid conflicting or overlapping regulation. According to the letter, starting the implementation of US regulation created uncertainty in the markets. Japan has apparently not applied its provisions extraterritorially in hopes of achieving an international coordination arrangement.

Also on December 13, 2012, Patrick Pearson[123] of the EC, testified in a hearing on Dodd-Frank Derivatives Reform[124] in which he discussed goals that can limit extraterritorial scope as much as possible and instead promote recognition and coordination. He isolated one key area where the EC believes further work is required to deliver reforms that will meet common objectives: "Our respective rules must also work on a cross-border basis. This is important because the $640 TR OTC derivative market is global. The Euro or the US dollar are the most important underlying currencies used for OTC derivatives. The global nature of OTC derivatives markets, with the two counterparties to transactions frequently located in different jurisdictions to each other, or in a different location to the infrastructure being used, makes the effective and consistent regulation of cross-border activity crucial."[125] First, he believes US regulators should coordinate margin rules with prudential regulators considering the SEC's proposals and the Basel/IOSCO working group findings and recommendations (discussed below). He also advocated

[121] Joint letter from George Osborne, Chancellor of the Exchequer, UK Government, et al. to Gary Gensler, Chairman, Commodity Futures Trading Comm'n., *US croff border swaps rules* (Oct. 17, 2012).
[122] Masamichi Kono, Vice Comm'r for Internal Affairs, Fin. Servs. Agency of Japan, Statement Before the Subcommittee on General Farm Commodities and Risk Management of the US House of Rep. (Dec. 13, 2012).
[123] Head of the Financial Market Infrastructures Unit at the European Commission. The European Commission is responsible for the preparation and enforcement of legislation in the European Union. The European Parliament and the Council are responsible for the final enactment of that legislation, while the European Commission, together with ESMA, has direct rulemaking powers in technical areas and in determining the equivalence of the rules of foreign countries.
[124] Patrick Pearson, Internal Mkt. and Servs. Directorate Gen., European Comm., Testimony at the House of Reps. Subcomm. on Gen. Farm Commodities and Risk Mgmt. Hearing on Dodd-Frank Derivatives Reform: Challenges Facing U.S and Int'l Mkts. (Dec. 13, 2012).
[125] Id.

for phase-in for margin requirements and consistent with ISDA's recommendation below, that IM not be required. For cross-border trades, he believes that affiliates of US persons should not be treated as US persons under the margin rules, as proposed by the CFTC in its cross-border guidance. For swaps involving multiple jurisdictions, non-US regulatory regimes should be recognized.

He claims that scope is the root cause of many cross-border problems identified. "The scope of persons who are subject to the application of our respective rules and regulations should be defined in the most narrow manner possible and be based on the establishment of the counterparty in the territory of our respective jurisdictions, where those jurisdictions have comparable and consistent requirements. What is important is that all the counterparties in two jurisdictions be subject to the requirements we all agreed to in the G-20 to ensure global safety." He believes that ensuring comparability is preferable to over-extending the reach of national rules. He advocates a territorial definition[126] for scope, as he believes that what ultimately matters is where the counterparties to a transaction are established, not the location where that transaction is concluded. The letter stresses that the principles of recognition, equivalence or substituted compliance are important foundations for a cross-border regulatory system. Substituted compliance will avoid the application of multiple rules to the same entity or the same transaction; as such, he believes substituted compliance should apply more broadly.

According to Pearson, key points to emphasize in discussions among regulators include (1) applying substituted compliance between a domestic and a third-country counterparty established in a jurisdiction with comparable and consistent requirements, and not restricting this approach only to transactions between two non-domestic counterparties, (2) applying substituted compliance to transaction level requirements between counterparties in different jurisdictions, and not simply to entity level registration requirements as US regulators have suggested (also recommended by the coauthors), (3) as for infrastructure such as clearing, foreign infrastructure which is subject to comparable requirements in its own jurisdiction should not be required to comply with domestic requirements in order to service the domestic market and (4) coordinating timing between EU and US rules so as not to obstruct cross-border business. As to (2), Pearson leaves open the issue of whose rules would apply to transactions in a substituted compliance regime regarding margin, collateral segregation. Additional open questions include whether the parties can choose which requirements are applicable, and if so, which party?

On February 6, 2013, MFA and AIMA jointly submitted a comment letter[127] to the CFTC on its "Further Proposed Guidance Regarding Compliance With Certain Swap Regulations." In the letter, MFA and AIMA expressed appreciation for the CFTC's proposed modifications to the "US person" definition, but also expressed continued concern with the breadth of the definition and its application to non-US funds. MFA and AIMA urged further coordination between the CFTC and other US and international regulators to avoid duplicative regulation and to address issues related to the practical details of how substituted compliance will work in practice.

ii. <u>Substantive OTC derivatives dialogue/IM requirement conflict</u>. In an attempt to achieve harmonization across jurisdictions and regulators, the Basel Committee on Banking Supervision and the

[126] "The scope of persons who are subject to the application of our respective rules and regulations should be defined in the most narrow manner possible and be based on the establishment of the counterparty in the territory of our respective jurisdictions, where those jurisdictions have comparable and consistent requirements. What is important is that all the counterparties in two jurisdictions be subject to the requirements we all agreed to in the G-20 to ensure global safety."
[127] Letter from Stuart J. Kaswell, Exec. Vice Pres. & Managing Dir., Gen. Counsel, Managed Funds Assoc. and Jiří Król, Dir. of Gov't and Reg. Affairs, Alternative Inv. Mgmt. Ass'n to David A. Stawick, Sec'y of the Comm'n, Commodity Futures Trading Comm'n, *Further Proposed Guidance Regarding Compliance with Certain Swap Regulations: RIN 3038-AD85* (Feb. 6, 2013), available at https://www.managedfunds.org/wp-content/uploads/2013/02/CFTC-Further-Cross-Border-Guidance-Letter-MFA-AIMA-Final-Letter.pdf

International Organization of Securities Commissions (BCBS-IOSCO) issued consultations on margin requirements for swaps that are not centrally cleared. Specifically, in July 2012,[128] Basel (or BCBS) and IOSCO released a consultive document on margin requirements for non-centrally-cleared derivatives, which the CFTC considered in its December 2012 exemptive order.

The consultation's goal was to propose minimum standards for margin requirements for non-centrally-cleared derivatives. BCBS-IOSCO agrees that margin can be viewed as offering enhanced protection against counterparty credit risk only where effectively implemented. Key principles of the document included that appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs. "The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the proposed requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally-cleared derivatives at issue and (ii) ensure that all exposures are covered fully with a high degree of confidence." There should be interaction among regulatory regimes so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions. BCBS-IOSCO asked many questions in the consultation.

ISDA responded on September 28, 2012.[129] Its recommendations included that there be no requirement for mandatory initial margin (IM),[130] but it did recommend posting variation margin (VM). The objection to IM stems from the risk that if IM is required, it would place enormous pressure on market liquidity with the potential for significant dislocation to the general economy, making the imposition of mandatory IM "inconsistent with the letter and the spirit of the G-20 leaders' recommendation." ISDA suggests that Basel and IOSCO consider provisions to limit the negative market impact and believes the margin requirements should be timed and linked to clearing requirements, such that the margin requirements for any class of derivatives should not apply until the clearing mandate for such class is implemented. Additionally, parties involved should determine eligible collateral. ISDA agrees with the exclusion of non-financial end users, sovereigns and central banks from margin requirements as well as exempting inter-affiliate transactions from IM collection. Finally, for cross-border OTC derivatives, ISDA applauds efforts for consistency between jurisdictions, in addition to timing coordination. However, instead of extraterritorial or conflicting regulation, "for cross-border OTC derivatives, we recommend that the regulations of the host country govern margin requirements." It appears that the host country is the jurisdiction in which the customer is located (as opposed to the dealer) and the rules of the host country should govern.

In a letter on December 2012[131] from the CEO of ISDA and Deputy Managing Director of IIF and Chief Executive of AFME on the consultation, the support for VM and against IM was emphasized, noting that IM could increase systemic risk. The letter notes that there is currently \$40 billion in IM posted at clearinghouses for over \$300 trillion of cleared OTC derivatives. The current proposal for

[128] Basel Comm. on Banking Supervision, *Margin Requirements for Non-Centrally-Cleared Derivatives,* Bank for Int'l. Settlements (July 2012).
[129] Letter from George Handjinicolaou, Ph.D, Deputy CEO and Head of ISDA Europe, Middle East and Africa to Secretariats of Basel Comm. on Banking Supervision and Int'l Org. of Sec. Comm'ns, *Consultative Document: "Margin Requirements for Non-Centrally-Cleared Derivatives"* (Sept. 28, 2012).
[130] ISDA strongly opposes the requirement for a universal two-way exchange of IM between financial firms and systemically important non-financial firms (Covered Entities) in the way that is described in the Study. The effects of the proposed rules are likely to lead to a significant liquidity drain on the market, estimated to be in the region of US\$15.7 trillion to US\$29.9 trillion for IM only.
[131] Letter from Robert G. Pickel, Chief Exec. Officer, ISDA et al. to Stefan Ingves, Gov. of Sveriges Riksbank and Chairman, Basel Committee on Banking Supervision and Masamichi Kono, Vice Comm'r for Int'l Affairs, JFSA and Chair of the IOSCO Board, IOSCO, *BCBS-IOSCO Proposal on Margin Requirements For Non-Centrally-Cleared Derivatives* (Dec.12, 2012).

margin for uncleared derivatives would require upwards of $800 billion to $1.7 trillion in IM for $127 trillion in uncleared OTC derivatives. The letter argues that the disproportionate charge is not justified, since enhanced capital charges for OTC derivatives already reflect the risk differential, and will have damaging consequences, including severely impacting liquidity in key sectors. ISDA believes that a three pillar framework is appropriate for ensuring systemic resiliency: (1) robust variation margin framework, (2) mandatory clearing for liquid, standardized products and (3) appropriate capital standards or exposure to OTC derivatives. [132]

SIFMA expressed concerns about applying the most stringent standard in response to Basel's consultative document.[133] It urged reconsideration of the proposal in the consultation to apply the more stringent of the home/host jurisdiction's[134] margin requirements when they are different, arguing that each jurisdiction should have a level playing field, and "apply the host jurisdiction's margin requirements so long as they are consistent with international standards. Imposing the more stringent of the home/host requirements will create competitive imbalances amongst parties competing for the same business."[135]

No models have yet been proposed by regulators in determining substituted compliance. The CFTC generally wishes for its transaction level rules to apply where a US person is party to a trade. European regulators and the SEC have suggested that substituted compliance should be available but do not have a rule of decision for which jurisdiction's rules apply to a cross border trade where the different jurisdiction's rules are comparable but not identical. Presumably, the parties would therefore get to choose. One approach in determining substituted compliance could be to use the jurisdiction of the customer where the customer transacts with a dealer and itself is not a dealer. Where both entities are dealers, an approach could be to use the rules of the jurisdiction in which the transaction occurs.

The FSB's Fourth Progress Report on Implementation[136] was positive about international reform in the OTC derivatives market. It recognized, however, that international coordination is key to fulfill the G-20's goals: "The global nature of OTC derivatives markets - where counterparties to transactions are frequently located in different jurisdictions to each other or in a different location to the infrastructure being used - makes globally consistent regulation of cross-border activity particularly important. In order to achieve the effective and consistent implementation of the G-20 objectives, international coordination is needed on the cross-border scope of regulations, and cooperation over their application, to avoid unnecessary overlap, conflicting regulations and regulatory arbitrage. Jurisdictions are working together, both bilaterally and multilaterally, to identify and address cross-border issues. However, progress to date in cross-border discussions has been slow." The FSB encourages discussions to quickly resolve any potential inconsistencies between regulatory frameworks and, where needed, agreement on coordinated

---

[132] Letter from Robert G. Pickel, Chief Exec. Officer, ISDA to Office of the Comptroller of the Currency, et al., *Re-Opening of Comment Period re: Margin and Capital Requirements for Covered Swap Entities – Comments on Margin Requirements* (Nov. 26, 2012). On September 14, 2012, ISDA and SIFMA commented in response to the CFTC's proposed rule for Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants with several key points: (1) reproposal of rules after considering the Basel/IOSCO study, (2) phased in implementation for margin, (3) consistency between margin requirements of jurisdictions and others including clarifying rules on cross-border swaps. In November 2012, ISDA also commented on the Re-Opening of Comment Period re: Margin and Capital Requirements for Covered Swap Entities – Comments on Margin Requirements, given the recently published study by Basel and IOSCO on margin requirements for uncleared swaps, the subsequent Quantitative Impact Study by BCBS-IOSCO, the proposed rules on capital, margin and segregation recently released by the Securities and Exchange Commission and the Prudential Regulators' additional request for comments. Similar to recommendations above, the key points included limiting IM and mitigating systemic risk with VM.

[133] Letter from Kenneth E. Bentsen, Jr., Exec. Vice President, SIFMA to Secretariats of the Basel Comm. on Banking Supervision and Int'l Org. of Sec. Comm'ns, *Consultative Document: Margin Requirements for Non-Centrally-Cleared Derivatives* (Sept. 28, 2012).

[134] Which also leads to the inquiry of which is host and which is home.

[135] Assuming the host country is where the customer is located.

[136] *OTC Derivatives Market Reforms Fourth Progress Report on Implementation*, Financial Stability Board (Oct, 31, 2012).

approaches across jurisdictions. This includes continuation of work by key, high-level OTC derivatives market regulators from G-20 jurisdictions.

e. Substituted compliance

There has been widespread support for substituted compliance. As mentioned above, substituted compliance is a concept where compliance with an equivalent non-US regulation will satisfy a US regulatory entity registration or transaction-level requirement, if the US regulator has determined that the non-US requirement is comparable to the Dodd-Frank requirement.[137] However, several issues with the concept are apparent. First, if the US requires separate entity registration for SDs and MSPs, how should the US use substituted compliance if the other jurisdiction does not require entity registration with respect to derivatives activity, but relies only on registration of financial institutions? Second, an international framework with respect to substituted compliance should be put in place based on whether it can be determined which jurisdiction's rules would apply, and whether substituted compliance would be available. The coauthors argue that both entity and transaction rules should be eligible for substituted compliance under such a framework. Entity level registration is straightforward. Transactional rules are more complicated. Which jurisdiction's rules should apply? Is it where the transaction occurs? If between a dealer and its customer (not a dealer) the rules of the jurisdiction in which the customer is located? Or where the dealer is because it may provide more of a threat to the financial system if it fails? What if the cross-border transaction is dealer to dealer? The most restrictive or should parties have choice, which would lead to the least restrictive and put pressure on substituted compliance assessments.

The EC embraces notions of substituted compliance and equivalence and would even broaden their scope. The SEC and the CFTC embrace substituted compliance making it clear that the exercise is not "all or none," which was equated with mutual recognition. John Ramsey, in his recent speech on the SEC's proposals on extraterritorial application notes that the SEC could allow foreign participants to follow the capital and margin rules of their home country if they were found to be comparable, while "at the same time, if the same regime did not have comparable reporting and transparency requirements, the SEC rules governing those elements would apply…clearing agencies, trade repositories, and swap execution facilities could be the subject of exemptions [from registration] if their home countries are found to have comparable rules in place to those that govern the same entities here."[138] While no other jurisdictions have laid out a view of how their rules would apply offshore, Ramsey notes that substituted compliance recognizes that different regulatory regimes can achieve the same outcome even if the rules are different and encourages global standards and dialogue by reducing risk.

No models have yet been proposed by regulators in determining substituted compliance. The CFTC generally wishes for its transaction level rules to apply where a US person is party to a trade. European regulators and the SEC have suggested that substituted compliance should be available but do not have a rule of decision for which jurisdiction's rules apply to a cross border trade where the different jurisdiction's rules are comparable but not identical. Presumably, the parties would therefore get to choose. One approach in determining substituted compliance could be to use the jurisdiction of the customer where the customer transacts with a dealer and itself is not a dealer. Where both entities are dealers, an approach could be to use the rules of the jurisdiction in which the transaction occurs.

[137] *US OTC Derivatives Reforms Impact on UK and Other non-US Asset Managers,* Investment Management Association (Oct. 2012).
[138] John Ramsay, Acting Dir., Div. of Trading and Mkts., US Sec. and Exch. Comm'n, *Cross-Border at the Crossroads: The SEC's "Middle Ground"* (May 15, 2013).

V. Proposals

Given the altered state of play due to delayed CFTC rules and exemptive orders, new SEC proposals and EMIR developments, in addition to the CFTC/SEC policy in limiting the extraterritorial scope and nature of the rules and the international embrace of substituted compliance and coordination, the coauthors' update their recommendations from *Examining the Extraterritorial Reach* in this section.

a. Minimum levels/guidelines; let parties choose

Adoption of global minimum standards for entities to transact on an international level field is one proposed solution. For example, if an entity such as BCBS proposed minimum requirements for clearinghouses to be met in order for one set of rules to apply to cross-border clearing and these standards were approved by the FSB, a solution might be to let the parties choose which clearinghouse to use without requiring that the clearinghouse be registered or qualified in each jurisdiction in which one of the counterparties was located. Minimum standards for clearing would mean that there is no need for dual registration. Instead, all parties will have access to a CCP if licensed in the country meeting minimum standards. This approach should reduce the number of CCPs, enhance netting and reduce costs.[139] Minimum standards can apply to transactional requirements as well. For example, if BCBS proposed minimum numerical requirements for OTC transactions (i.e., IM and VM for example depending on type of transaction), which were approved by the FSB, the parties can choose if both countries meet the standard, or transact in the country where the minimum standards are met if not in both. Minimum standards could involve alternative approaches. For example, they could require either initial margin for OTC contracts or enhanced capital requirements applicable to both counterparties, thereby dealing with the controversy over IM. While deference to standard setting bodies might be contentious in those countries, especially weaker ones as it may lead to losing autonomy in their national regulation, agreement over minimum standards by individual nations can ultimately be the stepping stone for more effective cooperation.

b. Substituted compliance

As noted above, the US, Asia and the EC embrace substituted compliance and the EC would broaden the CFTC's definition in its application. While the CFTC and SEC have noted that there are multiple factors to be considered, the framework by which these factors are to be considered is yet to be defined. In assessing comparability, similar to the proposal above, compliance with minimum standards set by international bodies can help in the determination. Otherwise, a rule by rule, case-by-case application would require regulators to move slowly and may impede business. Further, given that many jurisdictional frameworks are not necessarily aligned, yet counterparties still engage in certain types of cross-border transactions that involve two nations, standards of comparability set on an international level is an important consideration. Although the G-20 established general principles for cooperation, as was the case previously, frameworks for implementation are the next step. This approach has support from numerous bodies, including APAC[140]: "We are of the view that one useful point of reference for substituted compliance assessment would be the foreign regime's compliance with applicable global standards set by international standard-setting bodies like the CPSS, IOSCO and the Basel Committee on Banking Supervision works for minimum standards."[141] Still, who measures compliance is an open

---

[139] However, using fewer CCPs poses the issue of systemic risk if the CCP fails so effective oversight of a CCP and resolution authority are important in this approach.

[140] Asia Pacific, comprised of countries in the Asian/Pacific region.

[141] Letter from Belinda Gibson, Deputy Chairman, Australian Sec. and Invs. Comm., et al. to Gary Gensler, Chairman of Commodity Futures Trading Comm'n., *CFTC's Proposed Guidance on Cross-Border Application of Certain Swap Provisions of Commodity Exchange Act ("Proposed Guidance")* (Aug. 27, 2012).

question but presumably the FSB or another neutral body would determine compliance. However, as noted above, global standards specific to the global OTC derivatives market or clearinghouse requirements would have to be proposed to make regulators comfortable with substituting a comparable regime's for theirs, but compliance in the past with other standards would provide comfort.

As we have seen, key regulators in the US agree in theory. On December 12, 2012, Gensler testified before the US House Financial Services Subcommittee on Capital Markets and Government Sponsored Enterprises.[142] For firms that do register with the CFTC, Gensler noted, "we are very committed to allowing for substituted compliance, or permitting market participants to comply with Dodd-Frank with comparable and comprehensive foreign regulatory requirements." On April 6, 2013, Chairman Walter of the SEC gave a speech[143] to the ABA about regulation of OTC derivatives – finding the middle ground, noting, "getting these cross-border issues right for OTC derivatives is crucial. I know that. And my domestic and international counterparts know that. Yet, as we build this new framework from the ground up and with a common set of goals, we must accept that each jurisdiction necessarily is approaching derivatives reform from a slightly different direction. Countries come at the process from different historical, legal and regulatory perspectives, and move forward at different speeds. No amount of effort is going to completely reconcile these differences. After many years of regulatory experience, I have learned that it may not be fruitful to try to convert one another to our own particular regulatory philosophies. Instead, we should continue to expend our energy on a search for compatible, rather than identical, approaches to cross-border issues." A compatible approach could be based on an outcome assessment, rather than rule by rule comparison.

In the SEC's proposal,[144] the SEC gives an example of what it means by an outcome based approach:

> [T]he Commission's proposed capital rules for nonbank security-based swap dealers differ from those that would be applicable to bank dealers as proposed by the prudential regulators in that the Commission's proposed capital standards are principally focused on the retention of highly liquid assets that can be distributed to customers. Assuming that the Commission adopts capital standards for nonbank security-based swap dealers as proposed, the Commission's comparability determinations regarding entity-level requirements would likely analyze separately the capital treatment of nonbank entities in jurisdictions that do not impose a comparable net liquid assets test. In performing such an analysis, the Commission would take into account the other principles, rules, and regulations of the foreign jurisdiction that may be relevant to the analysis. It also would consider whether nonbank dealers in that jurisdiction are permitted to hold more illiquid assets as regulatory capital compared to the assets permitted to be held under the capital rules adopted by the Commission and, if so, whether nonbank dealers in that jurisdiction have access to sufficient liquidity at the entity level to support the liabilities they incur out of their business activity.1133 Similarly, the Commission would need to consider the impact of any reduced liquidity associated with the application of foreign capital standards on the ability of nonbank dealers in such jurisdiction to wind down operations quickly and distribute assets to customers. As this example illustrates, however, even when separately analyzing capital requirements, the Commission's focus would remain on ensuring not that the foreign jurisdiction has identical rules but on ensuring that a foreign jurisdiction that applies capital rules that do not impose a comparable net liquid assets test to nonbank security-based swap dealers can achieve the regulatory outcomes comparable to those intended under the Dodd-Frank Act.

Considering efficiency, instead of a line-by-line comparison of rules, an outcome-based approach is recommended. It is also of note that an outcome-based approach is closer to the equivalence standard of the EU since it precisely avoids a detailed rule by rule comparison.

---

[142] Gary Gensler, Chairman, US Commodity Futures Trading Comm'n, Testimony Before the U.S House Financial Services Subcommittee on Ca Markets and Government Sponsored Enterprises, Washington, DC, (Dec. 12, 2012), available at http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-129

[143] Elisse Walter, Chairman, US Sec. and Exch. Comm'n, Remarks at American Bar Assoc. Spring Meeting, *Regulation of Cross-Border OTC Derivatives Activities: Finding the Middle Ground*, (Apr. 6, 2013), available at http://www.sec.gov/news/speech/2013/spch040613ebw.htm

[144] See fn 68.

For the end user and affiliated transaction question, if extraterritorial rules are triggered, a jurisdictional approach can apply. With respect to the former, the rules that should apply should be where the end user is located since that is the jurisdiction to which it poses the most risk. With respect to the latter, the rules that apply should be the country where the parent is located because of the contagion risk, with flexibility to exempt. Conflicting rules of the host jurisdiction in these two limited cases should not even be considered as they do not pose the same risk as in the counterparty question.

c. FSB can take on broader role

The G-20 has encouraged development of international standards and has looked to existing international organizations to develop them and assess compliance. In 2011, the G-20 agreed to add margin requirements to non-centrally-cleared derivatives to the reform program and called upon the BCBS and IOSCO to develop, for consultation, consistent global standards for these margin requirements. Towards this end, and as discussed above, the BCBS and IOSCO, in consultation with the CPSS and CGFS, formed the Working Group on Margining Requirements (WGMR) in October 2011 to develop a proposal on margin requirements for non-centrally-cleared derivatives.[145]

The FSB and G-20 have provided fora for countries to communicate and in which to develop international principles. As such, the FSB can take on a greater, more binding role in the derivatives area. The G-20 has already tasked others including the FSB for evaluation of derivatives; it could also task the FSB with evaluating central clearing and to develop a framework for substituted compliance as well as assessing compliance with new derivatives regime on an outcomes oriented basis. Indeed, the FSB has experience in assessing compliance. On November 2, 2012,[146] it published an update of information on the jurisdictions evaluated to date under its initiative to encourage the adherence of all countries and jurisdictions to regulatory and supervisory standards on international cooperation and information exchange. Of the 61 jurisdictions evaluated by the FSB (selected on the basis of their financial importance), 44 demonstrated sufficiently strong adherence to the relevant regulatory and supervisory standards on international cooperation and information exchange.[147] Fifteen others are taking the actions recommended by the FSB but have yet to demonstrate sufficiently strong adherence. As noted in the November 2011 public statement, a very small number of jurisdictions elected not to engage in dialogue with the FSB. All FSB jurisdictions declare their commitment to centrally clear standardized derivatives. Given its knowledge about jurisdictions' implementation of rules consistent with international goals, the FSB could, in addition to assessing compliance, take on a greater coordinating role, as bilateral agreements are inefficient given the global nature of the markets.

The FSB could also provide a useful forum for fostering dialogue to develop consistent standards, either by developing minimum standards (or mandating that other bodies such as BCBS help develop them) or determining a framework for substituted compliance to be assessed, answering key questions such as when extraterritoriality should be triggered, and if it is triggered, whether substituted compliance could or should apply; if not, whose rules should apply? Last, the FSB could develop standards for when

[145] Basel Comm. on Banking Supervision, *Margin Requirements for Non-Centrally-Cleared Derivatives*, Bank for Int'l. Settlements (July 2012)
[146] Press Release, Financial Stability Board, *Update on global adherence to regulatory and supervisory standards on international cooperation and information exchange* (Nov. 2, 2012)
[147] Adherence was evaluated by the FSB based on the latest available detailed assessment report underlying the IMF-World Bank Report on the Observance of Standards and Codes (ROSC), as well as on the signatory status to the IOSCO Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information (MMoU). The acceptance by IOSCO of a jurisdiction as a signatory to the MMoU is evidence of that jurisdiction's adherence to standards of cooperation and information exchange that, for the purpose of the FSB's current initiative, is considered to be of strength equivalent to an assessment of full compliance with the relevant securities standards through an IMF-World Bank assessment. The FSB encourages all jurisdictions to take the steps necessary to meet the standards set by the IOSCO MMoU. Id.

derivatives should be centrally cleared, assess progress and provide a forum for discussion of minimum standards for OTC transactions.

The Institute of International Finance (IIF) recently drafted a set of recommendations for the issues referenced in this paper and has also recommended an international framework. Noting that "from the start, they [policy makers] have recognized that agreeing to international commitments is one thing: ensuring that they are implemented effectively and consistently across jurisdictions is another. Policy makers and regulators have consequently put in place processes to monitor and review implementation and address inconsistencies that emerge."[148] The paper outlines the benefits of international consistency and provides sixteen recommendations for action to achieve it.[149] Its main points are that international

---

[148] *Promoting Greater International Regulatory Consistency* (June 2013)

[149] Id. Regulatory Policy Initiation and Development

1. When contemplating regulation to address an emerging risk or concern, national regulators should inform the FSB and other relevant international standard setters such as the International Organization of Securities Commissions (IOSCO), the International Association of Insurance Supervisors (IAIS) and the Basel Committee on Banking Supervision (BCBS), and consider and consult with each other on whether an international approach would be beneficial, feasible, and timely, and how much of a priority this should be. This consideration should include whether there might be benefit in a common approach for some, but not all, jurisdictions. 2. The FSB and other international standard setters should continue to proactively identify areas requiring a coordinated approach and review existing regulation, coming forward with suggestions for where greater consistency is needed. 3. Even if there is agreement that a purely national regulatory approach should be taken on a given issue, national regulators should coordinate the timing of their regulatory processes as much as possible and should carefully consider whether the proposed regulation is likely to have an extraterritorial impact. If necessary, they should engage with other regulators to mitigate this impact. 4. All international standards proposed should represent a sensible balance between consistency and local flexibility in terms of the level of detail agreed and whether a minimum or maximum harmonization approach is used. They should be accompanied by an impact assessment showing their likely effects on global and national financial stability, end-users, financial institutions, and the wider economy, including consideration of effects on both developed and emerging markets. 5. International standard setters should set realistic deadlines for agreement and allow adequate time for consultation on proposed international standards.

Regulatory Implementation

6. Where international standards are agreed, the international standard setter, or a group of jurisdictions assisted by the international standard setter, should be able to develop more detailed common understandings of how they will interpret those standards with a view to assisting mutual recognition between jurisdictions. The FSB and other international standard setters should commit to the goal of mutual recognition between jurisdictions and look to promote it, including by developing a framework for mutual recognition to occur. 7. Throughout the implementation process, national regulators should work through the FSB and other international standard setters to coordinate regulatory consultations and the timing of implementation as much as possible. 8. In implementing commitments, where regulators identify fundamental problems in international standards that they believe need to be addressed through limited exceptions or where they wish to go further, they should alert the FSB or relevant international standard setter and discuss these exceptions or extensions with other regulators with a view to reaching a common view on how to proceed. International standard setters should create and maintain a database of interpretations of particular G20 commitments or international standards. 9. Where FSB Peer Reviews or other reviews of national implementation identify differences in national implementation that could create conflicts, uncertainty, or other problems including extraterritorial application, there should be a process for reconciling these differences or providing clarity of application for them. The FSB or other relevant international standard setter should publicly report any material inconsistencies by national regulations with international standards. 10. Leaders should task the FSB to develop recommendations for longer-term approaches to ensuring proper and effective implementation in all jurisdictions and to resolving differences.

Cross-Border Supervision

11. Supervisors should move beyond information-sharing in colleges and towards using them to ensure that decisions are understood and coordinated across supervisors, and consistent insofar as possible. Supervisory authorities represented in colleges should send a sufficient amount of senior staff or team leaders with thorough knowledge of the institution. 12. The FSB and BCBS should strengthen the role of crisis management groups, particularly on information exchange, and provide guidance to supervisors and resolution authorities on their role and relationship with supervisory colleges. 13. The FSB should examine whether there are unnecessary barriers to the transmission of financial information between supervisors and what action needs to be taken. 14. The FSB should commission academic work on the economic costs and benefits of international consistency. 15. The FSB should carry out a review of the organization of international regulatory work and the membership and resources of international standard setters. 16. Policy makers and international standard setters should consider how they can best improve transparency, communication, and consultation with national legislators and industry. As part of this, the FSB should establish a

consistency is important for many reasons, including comparability and predictability of outcomes so that institutions can offer efficient cross-border services. The main idea of the recommendations is that national regulators, where possible, should work with each other to "identify international solutions, coordinate timing and consultations, resolve differences of implementation, and limit national exceptions. In some areas, there might be benefit in work by some, but not all, jurisdictions under the coordination of the FSB, BCBS, IOSCO or IAIS to develop common regulatory approaches or more detailed common understandings of how they will interpret already agreed international standards or commitments. This could facilitate mutual recognition, substituted compliance or other cross-border cooperation." Therefore, whether it be for minimum standards, or to promote coordination for substituted compliance or provide a general forum for discussion, the FSB can play a crucial role in achieving international efforts to coordinate.

In Jill Sommers' speech before the US House in December 2012,[150] she discusses the November 28, 2012 meeting of regulators from Australia, Brazil, the European Union, Hong Kong, Japan, Ontario, Quebec, Singapore, Switzerland and the United States in New York. The leaders supported the adoption and enforcement of robust and consistent standards in and across jurisdictions, and recognized the importance of fostering a level playing field for market participants, intermediaries and infrastructures, while furthering the G-20 commitments to mitigating risk and improving transparency. The leaders identified five areas for further exploration, including: (1) the need to consult with each other prior to making final determinations regarding which products will be subject to a mandatory clearing requirement and to consider whether the same products should be subject to the same requirements in each jurisdiction, taking into consideration the characteristics of each domestic market and legal regime; (2) the need for robust supervisory and cooperative enforcement arrangements to facilitate effective supervision and oversight of cross-border market participants, using IOSCO standards as a guide; (3) the need for reasonable, time-limited transition periods for entities in jurisdictions that are implementing comparable regulatory regimes that have not yet been finalized and to establish clear requirements on the cross-border applicability of regulations; (4) the need to prevent the application of conflicting rules and to minimize the application of inconsistent and duplicative rules by considering, among other things, recognition or substituted compliance with foreign regulatory regimes where appropriate; and (5) the continued development of international standards by IOSCO and other standard setting bodies. Addressing the issue of practicality of coordination, these goals are consistent with the frameworks outlined by the coauthors in *Examining the Extraterritorial Reach* but can be brought to fruition if the FSB can enforce them in more ways than outline them as goals, in both ensuring compliance with global goals, fostering dialogue to coordinate rulemaking and by applying substituted compliance or jurisdictional assessments for which rules apply in the extraterritorial context, both on an entity and transaction level to account for consistency. The FSB can choose how to foster this dialogue whether it be though checklists, agreements, releases or other. The penalties of noncompliance are not within the scope of this update but undoubtedly will be the subject of future discussion.

d. Modified proposals from Examining the Extraterritorial Reach

Revisiting the different frameworks proposed in *Examining the Extraterritorial Reach* given the current state of play, it is likely that coordination and cooperation will continue to be the main driver in enforcing safe, efficient global derivatives markets. Bilateral agreements, although helpful, will likely need to be expanded into multinational agreements, given the importance of Asia, Europe and the United

---

formal industry advisory committee or set of committees to meet on a regular basis and discuss economic and regulatory issues of mutual concern.

[150] Jill E. Sommers, Comm'r, US Commodity Futures Trading Comm'n, Statement Before the US House of Representatives Committee on Agriculture Subcommittee on General Farm Commodities and Risk Management (Dec. 13, 2012)

States in the derivatives space.[151] Mutual recognition and effective cooperation agreements are still important, but more so on a multinational scale, with substituted compliance and multinational agreements as key.

While harmonization is challenging and not necessarily ideal, a supranational standard setting body such as BCBS tasked with setting minimum standards for OTC derivatives is a plausible response (as discussed above), along with an ISDA-like standard between counterparties that transact regularly. Mutual recognition can still take place where extraterritoriality is not mandatory but exemption in conjunction with substituted compliance seems more likely in light of the cross-border nature of OTC derivatives transactions. For example, on July 26, 2012, the US Treasury released a model intergovernmental agreement (IGA) for purposes of the US "Foreign Account Tax Compliance" (FATCA) and establishes a framework for bilateral negotiations between the US and G5 countries. Relying on existing treaties and local rules so as not to subject institutions to more burdensome requirements, the Model IGA is an example of a high level set of principles/coordination between countries that may serve as a stepping stone. On the derivatives front, a model agreement can be released to encourage discussions to either coordinate rulemaking or make determinations on comparability of approaches.

When mutual recognition was first proposed, the issue was efficiency of transactions between nations. Now, as substituted compliance is proposed, the issue is to prevent contagion and to enforce compliance, while still trying to encourage transactions. As such, regulators are likely to be much more wary unless the host country's approach and enforcement history is substantially similar, and reluctant to embrace the whole of a host country's regulatory structure. Substituted compliance focuses on one or more important features of cross-border transactions and determines comparability on these features only, as contrasted with EU equivalence efforts, where comparability is determined based on a broad portion of another jurisdiction's rules to determine whether they should be deemed comparable and reciprocity is involved.[152] Substituted compliance enables a common ground to be established more readily, reducing conflicts in cross-border transactions. It should be applied on an outcomes based approach, and not rule by rule.

VI. <u>Conclusion</u>

Ultimately, coordination and cooperation are critical and regulators appear to be moving in the right direction in terms of recognizing that their own countries' rules cannot exist in a vacuum. However, these words are general, and the devil is in the details. Thus, progress to date is far from complete in achieving the goals contemplated by the G-20. On October 31, 2012, the FSB published its fourth progress report on the implementation of OTC derivatives market reforms.[153] The key messages of the report were: (1) market infrastructure is in place and can be scaled up; (2) the international policy work on the four safeguards for global clearing[154] is substantially completed and implementation is proceeding at a national level; and (3) regulatory uncertainty remains the most significant impediment to further progress and to comprehensive use of market infrastructure. Jurisdictions should put in place their

---

[151] The FSB published a third progress report on implementation of OTC derivatives market reforms on June 15, 2012 where it noted that jurisdictions with the largest markets in OTC derivatives were the EU, Japan and the US.
[152] John Ramsay, Acting Dir., Div. of Trading and Mkts., US Sec. and Exch. Comm'n, *Cross-Border at the Crossroads: The SEC's "Middle Ground"* (May 15, 2013)
[153] *OTC Derivatives Market Reforms Fourth Progress Report on Implementation*, Financial Stability Board (Oct. 31, 2012)
[154] (1) Fair and open access by market participants, (2) Cooperative oversight arrangements between relevant authorities, both domestically and internationally and on either a bilateral or multilateral basis, that result in robust and consistently applied regulation and oversight of global CCPs, (3) Resolution and recovery regimes that aim to ensure the core functions of CCPs are maintained during times of crisis and that consider the interests of all jurisdictions where the CCP is systemically important, (4) Appropriate liquidity arrangements for CCPs in the currencies in which they clear.

legislation and regulation promptly and in a form flexible enough to respond to cross-border consistency and other issues that may arise. Regulatory uncertainty will remain a burden until a framework for coordination instead of promises to coordinate is introduced; these workable frameworks in light of the new issues have been the focus of this update.

Recently, in April 2013,[155] finance ministers from nine jurisdictions (including senior politicians from the European Union, UK, France and Brazil) wrote to Treasury Secretary, Jack Lew, outlining their concern over the lack of progress in developing workable cross-border rules for the over-the-counter derivatives market. The ministers fear that "without clear direction from global policymakers and regulators, derivatives markets will recede into localised and less efficient structures, impairing the ability of business across the globe to manage risk" and therefore advocate an approach that involves coordination among regulators and adherence to two core principles. These principles are that "cross border rules should be adopted that, if they were replicated by all other jurisdictions, would not result in duplicative or conflicting requirements, or regulatory gaps" and "this should be achieved through substituted compliance or equivalence arrangements." The letter further makes the point that registration requirements on foreign firms are an unnecessary burden, but to the extent that they exist, they should be accompanied by substituted compliance. The letter also contemplates that substituted compliance should be available to all market participants, should be assessed at the level of the jurisdiction and should use an outcome-based approach. The theme of this recent letter is the theme of this paper: without coordination and substituted compliance, the cross-border derivatives market will suffer. As such, regulatory dialogue is only the beginning; the use of the aforementioned proposals is key to developing a framework for coordination to achieve workable standards in the cross-border derivatives market.

[155] Joint letter from Guido Mantega, Minister of Fin., Gov't of Brazil, et al. to Jacob J. Lew, Sec. of the Treasury, US Dept. of the Treasury, The U.S. of America, *Cross-Border OTC Derivatives Regulation* (Apr. 18, 2013), available at http://www.fsa.go.jp/inter/etc/20130419-1/01.pdf Additionally, the FSB met in Tokyo in October 2012 discussing vulnerabilities that affected the global system, one of which was OTC derivatives reforms. Members were encouraged that the market infrastructure is in place and does not need to impede on G-20 commitments, but expressed concern on unresolved issues in cross-border application of regulation.